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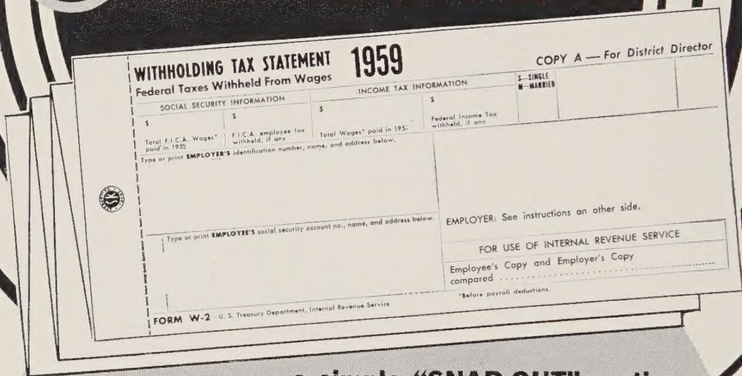

WITHHOLDING TAX STATEMENT 1959

Federal Taxes Withheld From Wages

COPY A — For District Director

SOCIAL SECURITY INFORMATION

INCOME TAX INFORMATION

S—SINGLE
M—MARRIED

Total F.I.C.A. Wages* paid in 195

F.I.C.A. employee tax withheld, if any

Total Wages* paid in 195

Federal Income Tax withheld, if any

Type or print EMPLOYER'S identification number, name, and address below.

Type or print EMPLOYEE'S social security account no., name, and address below.

EMPLOYER: See instructions on other side.

FOR USE OF INTERNAL REVENUE SERVICE

Employee's Copy and Employer's Copy compared

*Before payroll deductions.

FORM W-2 U. S. Treasury Department, Internal Revenue Service

THE ILLINOIS

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THE ILLINOIS SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS

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The opinions expressed by the authors of articles appearing in this magazine are their own, and frequently are intended to stimulate further discussion on the subject. Publication of any material does not necessarily mean that the Society, its Board of Directors, or editors approve or agree with the opinions expressed by the authors. Readers are invited to submit their own comments or articles.

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PRESIDENT'S PAGE

What did you think about at the Award Dinner on Monday evening, April 20th? This was a memorable occasion with a fine dinner, an outstanding address by a very competent speaker, presentation of the gold and ilver medals to the two top candidates ınd, finally, the presentation of CPA ertificates to the one hundred forty-even successful candidates from the November, 1958 examination. Nearly even hundred persons joined us in ıonoring the new CPAs who were a ine looking group of young people. I ıave no doubt that most of them are lunging enthusiastically into their areers in public accounting.

The Society's Awards Dinners are omparable to graduation exercises ince degrees are awarded in both. n most such occasions the successful andidates are given advice from their lders which they promptly forget uch as, "academic achievement is o guarantee of success," "there are reat new worlds to conquer," and "success will come to those who apply themselves and work diligently." I would like to reverse this procedure and, instead of giving advice to the new CPAs, address myself to my contemporaries, the older generation of practitioners, and ask:

What do the new CPAs have the right to expect from us? When we offer them employment and they become members of our staff, what do we owe them?

I am sure that my list is not exhaustive and that some of my fellow practitioners will differ with me in it. But here are the things I believe the new members of the profession may expect from us:

Reflection of professional attitudes and professional leadership so that new CPAs will be proud to be associated with you.

Interest in the development of the individual on the part of the principals of the firm, including constructive criticism, words of commendation when earned and availability for counsel and advice.

Opportunity for advancement as rapidly as the individual has gained necessary experience and has demonstrated capacity for increased responsibilities.

Reasonable compensation at all times, which should include appropriate recognition of increased experience and responsibilities and recognition of changes in wage levels and cost of living.

Opportunities to develop both professionally and socially through participation in professional or-

ganizations and community affairs.

Management of your practice so that outstanding men develop and are admitted to partnership under a plan designed so that these men may eventually succeed to senior partnership in a firm that will long continue.

In these days when we hear a great deal about the competition from industry for outstanding young men, we need to consider what new CPAs may rightfully expect from us as practitioners and employers. Let us hope that when our new associates consider us critically, we measure up to their expectations.

THE UNWANTED DIVIDEND

By Harry I. Grossman

The unwanted dividend, like the gout, is a scourge which seems peculiarly to seek out the citizens in high brackets, the prospectors for long-term capital gains, those who would not consciously take unto themselves any additional ordinary income. Its favorite spawning place is the closely held, usually family-owned, corporation.

Generally, the unwanted dividend is in the nature of a payment of money or transfer of property to or for the benefit of a shareholder in a corporation which payment or transfer, although assuming the outward form of something else, is nevertheless deemed to be a distribution of corporate earnings to the shareholder. The unwanted dividend may come into being through an unwitting course of action which is specifically proscribed in the law itself, or may be imposed upon a taxpayer through a construction applied against a set of facts by a court of law. In the sad wake of the unwanted dividend is the determination that a shareholder has received ordinary income in a transaction where he had anticipated either long-term capital gain, or no taxable income whatever. Another result may be that the distributing corporation is denied a deduction for an ostensible loss or a payment that in the first instance had been viewed as an ordinary and necessary expense of doing business.

Section 316 of the Code in so many words defines the term "dividend" as a distribution of property made by a corporation to its shareholders out of its earnings and profits accumulated after February 28, 1913. This definition is but the innocent lid to a Pandora's box which has been erupting since the earliest beginnings of the income tax law.

The Code particularizes only in an extremely limited extent with respect to specific situations which will generate ordinary dividends. Beyond that the taxpayer is on his own. For example Section 304(b) (2) points out that redemptions of shares held by a controlling shareholder in one corporation effected through the use of a related controlled corporation may result in a dividend to such shareholder. Similarly Section 356(a) (2) makes it plain that reorganization exchanges and spin-offs may yield ordinary dividends where boot is involved.

Another warning is contained in Section 302 treating with distributions in redemption of stock. That section delineates the area within which such redemptions will be deemed exchanges qualifying for capital gain treatment. Section 302(b) (1) provides that the exchange treatment referred to above shall apply only if the redemption

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"is not essentially equivalent to a dividend." This last proviso is one of the most foreboding in all income tax literature.

Dividends which come as a surprise to a shareholder who has caused corporate action to be taken in contravention of a forthright provision of the law certainly come to him no less painfully because he was unaware of such law, but he is charged with a knowledge of the statute and at least can said to have been warned by the plain letter of the law. A taxpayer charged with the receipt of a dividend by judicial construction, however, may sometimes feel that the law is written in two parts: one part spread on the statute books, the other held behind the Commissioner's back waiting for the unwary to fall into the pit. The point is, of course, that wherever a taxpayer contemplates dealings with his closely-held corporation which involve substantial sums or do not precisely square with the tenor of dealings between strangers, it is a recklessness of the first order not to avail himself of counsel *beforehand.*

The problems of constructive dividends are subtle ones and their treatment and solution call for a sweeping and trenchant comprehension of the taxing statutes, the regulations, legislative history, and business practice. Like problems in depreciation each case will stand or fall on the peculiar facts in the specific case. Oft times subjective and difficult ascertainments of intent are involved.

Legion and many-hued are the rocks from under which constructive dividends have been known to crawl. Some unwanted dividends have stemmed from painfully obvious contrivances naively designed to convert a distribution of earnings into something less burdensome taxwise merely by calling an onion a rose. At the other extreme are situations involving such attenuated considerations of tax law as to divide courts steeped in the subtleties which pervade the whole field of income taxation. The primary and, indeed, ultimate guideposts in this area are the court cases which are decided from day to day. These guideposts mark out an undulating line, sometimes changing directions completely. No one holding himself out to be well-informed in the field can afford to turn his back for any length of time on the stream of decisions which flow uninterruptedly from the Tax Court and the higher tribunals.

In the words of the time-honored phrase which attends papers of this kind, it is impossible to cover the whole range and depth of the constructive dividend problem within the time and space allotted. A few examples of situations commonly encountered in dealings of closely-held corporations and one or two unusual cases, however, will serve to highlight the nature of the problem.

Excessive Compensation

One of the most commonly met constructive dividends arises from excessive compensation paid to officer-shareholders of closely held corporations.[1] Officers' compensation offers a battleground with limitless facts. Because there is no immediate independent restraint on the dealings between a corporation and its controlling shareholders, compensation arrangements are viewed most critically by the Service.[2] That portion

[1] See Sec. 1.162-8 of Regulations under 1954 Code.

[2] Bluegrass Plant Foods, TCM 1958-53; Golden Construction Co., 228 F. 2d 637 (CA-10, 1955); Standard Asbestos Mfg. and Insulating Co., TCM 1958-42.

f compensation payments which is ound to be excessive and deemed a onstructive dividend to the recipient s also denied as a deduction to the orporate employer.

Compensation to officer-shareholders hould accord with the general execu- ive salary levels prevailing in the usiness in which the corporation is ngaged. Special skills and respon- ibilities, of course, may be rewarded s they would be in the case of a hird-party relationship, but probative acts should be at hand to buttress ny apparent deviation from the ormal. Many other considerations ssert themselves in a determination f reasonable compensation in these ases, but perhaps most prominent mong them are the questions of vhether compensation is proportion- te to stockholdings and whether it luctuates according to the income of he corporation. Affirmative answers o these questions are dangerous. A iggardly corporate dividend policy ikewise will accentuate the difficulty f one exists.

Salaries paid to wives who render o services to the corporation or loated salaries paid to the president's on fresh from college also are vul- erable to constructive dividend reatment. The fact that these mem- ers of the controlling shareholder's mmediate family are themselves not hareholders may not stave off the ividend taint under circumstances emonstrating the excessive payments o have been made for the personal enefit of the shareholder himself.

AYMENTS TO WIDOWS OF OFFICERS

Payments by corporations to wid- ws of deceased officers in recogni- ion of the officers' past services and aluable contributions to the progress f the corporations' affairs have been recognized as a deductible ordinary and necessary expense of the corpor- ate business.[3] But where such pay- ments are made in consideration of stock ownership, the constructive dividend question bestirs itself.

In the recent case of *Standard Asbestos Mfg. and Insulating Co.* TCM 1958-42, the corporation made certain so-called "pension payments" to the widow of a deceased officer-shareholder pursuant to an agreement between the controlling shareholders that they would cause the corporation to pay the widow one-half of the average salaries of the decedent and his sons prevailing for the quarter preceding the date of death so long as the widow retained stock in the company inherited by her. The court held that the primary purpose of the payments was to discourage the widow from disposing of her stock, not to pay compensation for past services, and accordingly the payments constituted distributions of company profits. The payments were disallowed as deductions to the corporation and were deemed properly includable in the widow's income.

EXPENSE ALLOWANCES

Somehow the notion had taken deep root among the taxpaying community that expense allowances paid by a corporation (or an employer for that matter) to its employees need not be accounted for in reporting taxable income. The statute, the regulations, the Treasury Department rulings, and the cases notwithstanding, there was a general understanding that expense allowances and reimbursements were supposed to "get lost." And they did.

The abuses in this area were wide-

[3] Rev. Rul. 54-625, C.B. 1954-2, 85, as modified by Rev. Rul. 55-212, 1955-1 CB 299.

spread and sometimes extreme. This was particularly true in the dealings between a corporation and its principal shareholders where the cold fishy eye of the company controller would not run interference between the officer's weekly expense report and the petty cash box. Beyond reimbursements for claimed expenses and flat expense allowances were corporate expenditures for the maintenance of yachts, hunting lodges and gentlemen farms claimed to be for the furtherance of corporate affairs but often found by the courts to be for the personal and social enjoyment of the controlling shareholders.

Cash reimbursements and allowances not supported by proof of expenditure on the part of the shareholder in pursuit of or in the interest of company business have not only been denied as deductions to the corporation, but have also been taxed as income to the shareholder. Likewise expenditures by the corporation for facilities and services availed of by shareholders for their personal pleasures have been denied to the corporation as deductions and have been taxed to the shareholders under the economic benefit theory.[4]

In recent times the Internal Revenue Service has responded most forcefully, and sometimes violently, in reaction to abuses in the areas of traveling and entertainment expenses, outer fringe benefits and noncash emoluments of office, particularly in closely-held corporations. In his wisdom Plato once said that the doing of anything to excess usually causes great change in an opposite direction. Now the Service is demanding more exact proof of expense items which often are of a nature which does not practically lend itself to a strict accounting. Field examiners attempt to carve out of accommodations extended to shareholder-officers for business purposes an element of personal benefit to them to be translated into dollar income, such as a portion of depreciation, insurance and other expenses of maintaining company automobiles, however inconsequential the proportion of personal use. The Commissioner has threatened and made fraud charges in the case of shareholders dealing with themselves in reckless disregard for the distinction between corporate business and purely personal activities.[5]

The pendulum has swung far and probably will come back to middle ground where it belongs. Witness, for example, the modification in the Commissioner's originally proposed rules for reporting employees' expenses on line 6(a) of last year's Form 1040. In the meantime, however, an awareness has seeped into the tax arena that a television set for the maid's room does not qualify as an ordinary and necessary expense of conducting the master's iron works.

There is one phase of the Commissioner's campaign against expense allowances in closely-held corporations which in the opinion of many students of the income tax law is clearly ill founded and probably will be productive of extensive controversy. In authorizing compensation for principal officers, the directors of the corporation, who often are the principal officers themselves, frequently vote a specified amount as salary plus a specified amount as an expense allowance. However labeled, the two amounts are essentially stipends for

[4] Louis Greenspon 23 TC 138 (1954) reversed on other grounds 229 F. 2d 947 (CA-8, 1956).

[5] Frank Fehr Brewing Co., 160 Fed. Supp. 631 (D.C. Ky. 1958).

lischarging the responsibilities of the ·orporate offices.

Wherever the officer has been unıble to prove to the satisfaction of the Treasury Department that the full ımount of the expense allowance has ›een disbursed for business purposes, he disallowed portion has not only ›een taxed to the officer individually, ›ut has also been denied as a deducion to the corporation. There is ·onsiderable feeling abroad that, if he authorized salary and the expense ıllowance together do not exceed an ımount which represents reasonable ›ver-all compensation in the circumtances, there is no proper basis for lisallowing the deduction to the cor›oration. There is at least one court ·ase to buttress this view.[6]

SALES AND RENTALS BETWEEN CORPORATION AND SHAREHOLDER

A sale of property by a corporation o a shareholder at a bargain price r a purchase of property from a hareholder by a corporation at a rice in excess of the fair value of he property may be construed as he distribution of corporate earnings o the shareholder measured in each nstance by the difference between the air value of the property and the rice charged or paid to the shareolder.[7] In any event sales or exhanges of depreciable property beween a shareholder and his controlled orporation should not be made withut considering the impact of Section 239 of the Code. Any recognizable ain on the sale of depreciable proprty, even in the absence of contructive dividend possibilities, will e taxable under that section as orinary income.

There is an intriguing question in the case of a tax-free exchange of property under Section 1031 between a shareholder and a corporation where Section 1239 would not immediately apply. What if the property received by the stockholder were subsequently sold at a substantial profit? Unless the exchanged properties had comparable fair values at the time of exchange and unless a corporate business purpose was being served at the time of exchange, the constructive dividend principle may well come into play.

In a recent Tax Court case[8] decided in August 1958, a closely-held corporation bought in the shares of one group of its stockholders at a price of approximately $380 per share which shares were then held as treasury stock. About a month later these treasury shares were sold to other shareholders at a price of $200 per share. The Court determined that the fair value of the shares so sold was $300 per share and that the difference between the fair value of the shares and the price paid constituted a dividend to the acquiring shareholders.

Bargain rental arrangements between a lessor corporation and its lessee shareholders are also fraught with constructive dividend dangers.[9] Where a corporation was formed to own and operate an apartment project for profit and its shareholders were allowed to rent apartments at less than the going rate charged to the general public, the excess of the market rental over the rent charged to the shareholders was ruled to be a constructive dividend to the extent of available corporate earnings.[10]

[6] See footnote 1 to decision in W. Horace Villiams, Sr. et al., 245 F. 2d 559. (CA-5, 1957).
[7] Stanley V. Waldheim 244 F. 2d 1 (CA-7, 957).

[8] Joseph Scura, TCM 1958-161.
[9] Limericks, Inc., 165 F. 2d 483 (CA-5, 1948).
[10] Rev. Rul. 58-1 I.R.B. 1958-1, 24.

Stockholder Borrowings from Corporation

Shareholders who borrow funds from their corporations without treating the loans as repayable obligations are inviting a charge that the "loans" are a distribution of corporate earnings. An example of what can happen is illustrated in the case of *Elliott J. Roschuni* 29 TC No. 127 (3/31/58).[11] There the daughter of the controlling stockholder of a group of related hotel corporations acquired control after her father's death by inheritance and by subsequent purchase of her mother's interest in certain shares. The daughter maintained an account with the principal managing corporation to which account she charged a number of her personal bills. Sundry payments to her personal creditors were made from time to time by the corporation and charged to the account. There were also charged to the account the payments made by the daughter to the mother for the latter's interest in the estate.

No serious effort had been made by the daughter to liquidate the obligation over the years, but after an examination was begun by a Revenue Agent the daughter deeded her home to the corporation and credited the ostensible value thereof to her account. Her husband leased the house back from the corporation at a stipulated rental.

The court held that these advances constituted distributions of earnings of the corporation to the daughter to the extent of earnings available for the payment of dividends. In its opinion the court quoted from the Commissioner's brief the reasons offered in support of the assertion that the advances should be taxed to the daughter as dividends. These reasons are listed below as a complete guide to those who would like to know what considerations move the Commissioner in a case of this kind:

(1) The corporations were closely held and controlled.
(2) No note, no interest, and no security were given to the hotel corporations by petitioners.
(3) There was no definite time specified for repayment of the amounts withdrawn.
(4) The withdrawals were substantial and for the petitioners' personal expenses.
(5) There was no apparent ceiling on the amount that could be withdrawn by the petitioners.
(6) The withdrawals were not to meet an unusual, nonrecurring emergency.
(7) The constant practice of withdrawing corporate earnings on open account with only negligible repayments over a long period of years indicates an established method of dividend distribution.
(8) The hotel corporations had a poor previous dividend record.
(9) There was no effort to enforce collection on the part of the hotel corporations.
(10) There was no plan or tangible means for repayment of the withdrawals by petitioners.
(11) There were no large credits to petitioner's account until after she had been contacted by the Revenue Agent.
(12) The hotel corporations had large surpluses.

The court was also influenced by the fact that the petitioner who made most of the withdrawals failed to testify. The case is now up on appeal.

Thin Corporations and Interest v. Dividends

Formation of a corporation by investment of small amounts of equity capital bolstered by heavy cash advances by the shareholders, denominated as loans, is surcharged with a possible constructive dividend back-

[11] Roschuni case now on appeal before CA-5. Also see Garden State Developers, Inc., 30 TC No. 13, 4/29/58.

fire on two counts: The interest may be disallowed to the corporation as a deduction, and principal repayments may be declared distributions of corporate earnings. Such treatment would be predicated upon the conclusion that the loans were not loans at all, but actually additional capital contributions.

Wherever the thin corporation question raises its head, there you will find discussion of the debt to equity capital ratio. As the Tax Court stated in a recent decision on a thin corporation issue,[12] "Although the cases are legion involving this question, they have carefully avoided establishing a rule of thumb for reaching a decision." There is no magical ratio of debt to equity capital which is a limit to which taxpayers may go with complete assurance. The equation 3 to 1 has been bruited about from time to time but is wholly without authority.

In an attempt to minimize controversies on this question, a suggestion was made to the Mills Subcommittee on Internal Revenue Taxation by one of the advisory groups in connection with the deliberations on technical amendments to the Code that, by definition, corporate indebtedness to a shareholder should be recognized as such in cases where the ratio of debt to equity capital does not exceed 5 to 1. The suggestion was not enacted into law. Investors should be aware that the ratio of debt to equity capital is not the sole factor to be considered and should know that some circumstances will draw them closer to the brink than others, equations notwithstanding.

Shareholders should avoid making loans in proportion to their stockholdings; loans should bear interest and be evidenced by formal instruments with definite maturities; they should not provide for repayment on the basis of corporate earnings; they should not be subordinated to claims of all outside creditors; it is well for such loans to be secured and not to be placed "at risk in the business" (whatever may be the precise meaning of that phrase which the courts have used repeatedly in decisions involving this point).

Each case must be decided in the light of its own peculiar facts, but at the core of every judgment there probably lies the answer to the nagging question whether, under those facts, a disinterested lender of money would have been remotely anxious or willing to make the loan.[13]

Where "loans" are deemed to be capital contributions for income tax purposes, repayments of principal as compared with interest on such loans will bear a much heavier tax burden since they would be in considerably larger amounts. Consequently it has been deemed advisable to effect no principal repayments until payment of interest on the loans has passed inspection in an income tax examination. In the alternative the suggestion has been made to arrange for principal repayments in smaller amounts over a longer period of time so that no substantial constructive dividends will pile up on the recipient's other income in any single year.

The disallowance of interest, or taxability of principal repayments as constructive dividends, is by no means only a problem of the newly-formed corporation. Stockholders' advances to their corporations of long standing may also be challenged as capital contributions whenever made. Securities

[12] Lockwood Realty Corporation, TCM 1958-49.

[13] Evard A. Matthiessen 16 TC 781 (1951) aff'd 194 F. 2d 659 (CA-2, 1952).

issued in a reorganization[14] are not in the safety zone nor is a so-called bond of a family trust where the bond in fact has the characteristics of preferred stock and where the trust is deemed an association taxable as a corporation.[15]

Pulling Assets Out of the Corporate Hangar

The distributions of all or a portion of a corporation's assets to, or for the benefit of, shareholders under the guise of complete or partial liquidations, of tax-free divisions, or reorganizations are fair game for the constructive dividend needle unless they are effected within the letter and spirit of those sections of the Code according favored treatment to liquidating distributions and divisive reorganizations.

Spin-offs which do not satisfy the Treasury Department's idea of conformance with the requirements of Section 355 will result in shareholders being charged with the receipt of a dividend in an amount up to the fair value of the spun-off assets. In a ruling issued during the past year (Rev. Rul. 58-54) the given facts were briefly, that a corporation operated a soft drink bottling and distributing business in four locations within a certain state. In recent years all of the bottling had been done at the main plant. The corporation sought to divide its business among four separate corporations, one at each location, and accordingly the assets at each of the three branches were transferred to three new corporations. The stock of the new corporations was then distributed among the shareholders of the original corporation. The ruling held that, since the activities in all the locations constituted an integral part of only one enterprise, the spin-off failed to qualify for tax-free treatment under Section 355. Accordingly, the distribution of the new corporate stock to the shareholders of the original corporation was deemed to be a dividend "to the extent provided in Sections 301(c) and 316 of the Code."

The liquidation of a corporation and subsequent reincorporation using a portion of the assets for operation of the newly-incorporated business likewise has the unmistakable makings of a constructive dividend. The sentiments of the Treasury Department on this point may be gleaned from the text of Section 1.331-1(c) of the Regulations which reads: "A liquidation which is followed by a transfer to another corporation of all or a part of the assets of the liquidating corporation or which is preceded by such transfer may . . . have the effect of the distribution of a dividend . ."[16]

An extreme illustration of the indigestion that can result from the eating of corporate cake and trying to have it too is in the recent decision of the Seventh Circuit in the *Kolkey* case.[17] Three shareholders owned all of the stock of a pharmaceutical company. They employed "finders" to locate a tax-exempt organization which would be interested in purchasing their stock in the corporation. Such an exempt organization (Survey Associates Inc.) was found. By agreement between the corporation and Survey a new corporation, Kryon Foundation, Inc., was created with a capital of $1,000, all of its shares

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[14] J. Robert Bazley 331 U. S. 737 (1947).

[15] The Hoersting Family Trust, TCM 1958 3.

[16] Wm. M. Liddon, 230 F. 2d 304 (CA-6, 1956); Cert. Den. 352 U. S. 824.

[17] Emanuel N. Kolkey et al., 254 F. 2d 51 (CA-7, 1958). See Estate of Ernest G. Howes, 30 TC No. 93 (7/11/58) for an interesting parallelism with a different result.

going to Survey. The three shareholders transferred all of their shares in the pharmaceutical corporation to Kryon in exchange for $4,000,000 in Kryon's notes, receiving as sole collateral the 10 outstanding shares of Kryon stock which Survey turned over, endorsed in blank, together with undated resignations of all Kryon directors and officers.

Kryon promptly liquidated the pharmaceutical company and used the assets to pay off $400,000 of the notes to the shareholders. The shareholders were also given a contract to manage Kryon's business for a period of seven years at annual salaries of $25,000 each. The taxpayers sought to report the gain on the sale of their shares to Kryon as capital gain on the installment basis. The court found that despite the transfer of the pharmaceutical shares to Kryon the shareholders continued to "maintain a death grip" on Kryon, that the $400,000 payment by Kryon to the shareholders was a dividend, and that the three stockholders continued to receive distribution of the pharmaceutical earnings in the form of interest and principal payments on the remaining notes issued by Kryon.

Insurance Contracts on Lives of Officer-Shareholders

Within the past year there has been considerable excitement over three cases involving insurance premiums paid by corporations on contracts covering the lives of their principal officer-shareholders. Such contracts, beneficially owned by the corporations, were carried for the purpose of funding stock redemptions or retirement and death benefits. The Commissioner took the position that the premiums in each instance constituted dividends to the shareholders. In each case the Tax Court upheld the Commissioner. Each Tax Court decision, however, was reversed by a Circuit Court of Appeals and, incidentally, in three different circuits.[18]

The Commissioner's line of attack was that the coverage taken out on the lives of the officer-shareholders was to provide funds to be expended under the redemption, death or retirement agreements for the personal benefit of those shareholders and thereby conferred an ascertainable economic benefit upon them equivalent to a taxable dividend. Each case had a different set of facts, of course, but in each case the Circuit Court in essence turned its decision on the points that the insurance contracts were property of the *corporation* and not that of the shareholders and that there was no immediate and severable economic benefit or interest of a taxable nature conveyed to the shareholder.

So that shareholders covered by corporate insurance of the type here involved may not think the problem has been permanently laid to rest, their attention is invited to the following last sentence of the Circuit Court's decision in the *Sanders* case: [18] "Upon the death or withdrawal of a stockholder, tax complications including the possibility of an assessment of constructive dividends may arise, but the solution of these dimly-foreseen and nebulous problems must await a clearer view."

It should go without saying, of course, that where an officer-shareholder and not the corporation is the beneficiary under a life policy and where the corporation pays the

[18] Oreste Casale, 247 F. 2d 441 (CA-2, 1957); Henry E. Prunier, 248 F. 2d 818 (CA-1, 1957); Robert V. Sanders et al., 253 F. 2d 855 (CA-10, 1958).

premiums, each premium payment will be deemed income to such beneficiary. Whether that income will be classed as a constructive dividend or as additional compensation will depend on the facts in each case.[19]

Stock Redemptions

The shareholder who wants to turn his shares into the issuing corporation for a capital gain has a fairly clear guide for achieving his end in Section 302 of the 1954 Code. The remaining shareholders in the redeeming, closely-held corporation, however, have suffered a traumatic experience during the past year which they won't easily forget. Two recent cases particularly have freighted the atmosphere with dismay and confusion regarding the position of those whom the redeemed stockholders left behind.

In *Louis H. Zipp*, 28 TC 314(1957) a family-owned corporation had 50 shares of stock outstanding of which the father owned 48 shares and each of two sons owned one share. Prior to taking a second wife in 1947, the father surrendered his old certificate representing 48 shares and had 3 new certificates issued: one for 23 shares in the name of one son, another for 23 shares in the name of his other son, and the last for 2 shares in his own name. The certificates for 46 shares were issued to the sons in order to insulate those shares from any claims which conceivably could be asserted against the father as a result of future marital difficulties and for other reasons. The sons endorsed the certificates in blank and turned them over to the father's lawyer. The father had no intention of actually making a gift of those shares to the sons. They were issued to the sons as nominees.

In 1950 a controversy arose between the father and the sons with respect to the management of the business and an understanding was had between the father and the sons that the former would sell his shares to the corporation for a stipulated price. The sons arranged for a loan to the corporation from one of the company's suppliers in order to finance the purchase of the father's stock by the corporation. At the time this understanding was had, the father executed a memorandum stating that he had no interest in the 46 shares previously issued to the sons and the final contract of sale with the corporation provided for the sale by the father of only 2 shares, being all the shares held in his name.

The Tax Court concluded that, despite the recital in the contract for the sale of 2 shares, the father actually sold 48 shares (each son receiving 23 shares) and that the purpose of the transaction was to enable the sons to purchase all of the father's interest in the corporation. The arrangements, said the court, had the same effect as though the sole stockholders had withdrawn funds from the corporation for their own use and benefit and the payment by the corporation to the father constituted taxable dividends constructively received by the sons.

Had the father retaken the shares held by the sons as nominees and sold the entire 48 shares to the corporation, the sons, holding one share each, would still have had the same measure of control over the corporation after the redemption as they did holding 24 shares each. Between them they would have owned all the outstanding shares of the corporation. Be that

[19] Paramount-Richards Theatres, Inc., 153 F. 2d 602 (CA-5, 1946); Canaday v. Guitteau, 86 F. 2d 203 (CA-6, 1936)) Also see Francis H. W. Ducros, 30 TC No. 141 (9/30/58).

as it may, if the court directed its appraisal of the situation strictly on the basis of form, it understandably could have arrived at the decision that corporate funds were used to buy 23 shares of the father's stock for each of the sons. But what about that portion of the purchase price which pertained to the 2 shares conveyed by the father directly to the corporation? If that portion also is to be deemed a constructive dividend to the sons, and that is what the court decided, then it would seem that the court was not completely sold on the doctrine of the separateness of corporation and shareholder in redemption cases of this type.

In a rather summary opinion, the Sixth Circuit affirmed the decision of the Tax Court on May 21, 1958, leaving a pall of judicial smog hovering over Subchapter C.

In the case of *Joseph R. Holsey,* 28 TC 962 (1957) Holsey owned 50% of the outstanding shares of a corporation operating a Chevrolet agency. It was the policy of the factory to have its dealers own all of the stock in the agencies operated by them. Holsey obtained an option to purchase the remaining half of the outstanding stock from the holder thereof for $80,000. The option was not assignable by Holsey except to a corporation in which he owned not less than 50% of the outstanding common stock. In 1951 Holsey assigned the option to his corporation which thereupon exercised the option. Holsey then became the owner of all the outstanding shares of the agency. The Commissioner found that the price paid by the agency in exercising the option constituted a constructive dividend to Holsey and the finding was upheld by the Tax Court.

The Court hinged its decision on the "net effect" theory, that is, if the net effect of the transaction was for the personal benefit of the stockholder, then a constructive dividend resulted. This line of reasoning can be carried to a conclusion that would have the shareholder and the corporation rolled into one conglomerate ball of wax in every and any corporate transaction. The Court said, "The payment was intended to secure and did secure for petitioner exactly what it was always intended he should get if he made the payment personally, namely, all of the stock in J. R. Holsey Sales Co. Clearly, the net effect of the transaction was the distribution of a dividend to petitioner." (Yes, but he did *not* make the payment personally. The corporation made the payment with its own funds.)

When the petitioner attempted to point out that the payment by the corporation was in furtherance of a corporate business purpose, the Court said further, "The corporation as an entity had not violated any policy of the manufacturer. It was not a corporate purpose to see to it that it have but one stockholder. It served the purpose of petitioner and not the corporation when it paid $80,000 out of earnings to aid petitioner in acquiring all the stock, in accordance with the manufacturer's policy." There seems to be a terrifying ambivalence here in at once merging the stockholder personality into the corporate being and yet finding their respective business purposes worlds apart.

The Tax Court recognized and announced that its decision in this case was directly contrary to the rationale of the Eighth Circuit's opinion in the case of *Tucker et al.* 226 F. 2d 177

(CA-8, 1955), involving a similar question.

An appeal was taken by Holsey to the Third Circuit and on September 3, 1958, that court (with one dissent) issued its opinion reversing the Tax Court and giving stockholders in closely-held corporations a new lease on life. The decision of the reviewing court turned on the point that Holsey was "never under any legal obligation to purchase the stock held by the other stockholder . . . having merely an option to purchase which he did not exercise but instead assigned to the Holsey Company," and ruled that the distribution did not discharge any obligation of Holsey and did not benefit him in any direct sense. Therefore, since the redemption did not effect a satisfaction of Holsey's direct obligation through the use of corporate funds, it did not constitute a taxable dividend to him. The indirect benefits which accrued to Holsey, the court said, could not give rise to taxable income within the meaning of the Sixteenth Amendment.[20]

To compound the concern in this area, the Seventh Circuit came out in the beginning of 1958 with its decision in the case of *Pelton Steel Casting Co.*, 251 F. 2d 278, (CA-7, 1958)[21] in which a minority shareholder owning 20% of the corporation's outstanding stock made financial arrangements to have the corporation purchase the remaining 80% from two other shareholders to keep them from selling the corporation and possibly ending its independent existence. The issue involved was an unreasonable accumulation of profits under Section 102 of the 1939 Code.

The Court found that the purchase and retirement of 80% of the corporation's outstanding stock did not serve a reasonable need of the corporation's business. The Court distinguished this case from two others upon which the petitioner relied[22] on the basis that in those two cases the majority shareholders bought out a minority, whereas in the *Pelton* case the minority stockholder remained in the corporation after the majority sold out. Apparently, there is strength in numbers.

For some strange reason no reference was had in the foregoing proceedings to the refreshing case of *Fox v. Harrison*, 145F 2nd 521 (CA-7, 1944) which would seem highly appropriate to the considerations in all of these cases. There, one Cross owned about two-thirds of the stock of a corporation, and Fox owned about one-third. Cross was heavily indebted to the corporation and sought to liquidate the indebtedness by a corporate redemption of a portion of his stock. When he was told it could not be done legally, he threatened to liquidate the corporation unless his stock was purchased at par value. Fox attempted to negotiate a bank loan for the corporation to buy out Cross, but failed. The bank was willing to make a personal loan to Fox, however.

Fox accepted the loan and purchased all of Cross' shares (over 1,400 shares) at $100 per share. Subsequently, the corporation acquired from Fox 1,000 shares of the stock

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[20] On October 30, 1958, the Internal Revenue Service announced that in the future it will not treat a redemption of stock as a dividend to the remaining stockholders unless the redeemed stock is in reality purchased by a remaining stockholder and paid for by the corporation. In the latter case the Service will consider the redemption as a dividend to the purchasing shareholder regardless of the form of the transaction. See Fred C. Niederkrome et al., CA-9, 11/10/58.

[21] Cert. Den., 78 S. Ct. 995.

[22] Dill Manufacturing Co., 39 BTA 1023 (1939); Gazette Publishing Co. v. Self, 103 F. Supp. 779 (D. C. Ark. 1952).

which he had purchased from Cross. The corporation paid Fox the same price that he had paid to Cross, namely $100 per share. The Commissioner sought to tax the payment to Fox as a dividend. The Court held that Fox realized no profit on the transaction and that the payment to him was not essentially equivalent to the distribution of a taxable dividend. Apparently, the Court felt that a corporate business purpose was being served when a minority shareholder made a personal loan in a transaction designed to effect the redemption of the shares of a majority stockholder in order to keep the corporation in existence and then sold the shares, or a portion of them, to the corporation at his cost.

The crux of these cases is a clarification of the principles of law concerned with the separate existence of the corporation apart from the persons owning its stock. The First Circuit in *Henry E. Prunier* 248 F. 2d 818 (1957) alluded to the point in taking issue with the theory of "disregarding the corporate fiction" whereby benefits flowing to a corporation in certain cases have been attributed to its shareholders directly. The Court stated, "In a loose manner of speaking, it can be said that any corporate gain is a benefit, indirectly to the stockholders, so that if a corporation becomes the beneficial owner of insurance policies, the stockholders receive the benefit thereof. Of course, this argument proves too much, for it would lead to the conclusion that profits made by a corporation in its business are automatically taxable income to the stockholders. This is contrary to the taxation scheme of the Internal Revenue Code."

As a last commentary on this point, it may be well to hark back to the opinion of Mr. Justice Pitney delivered 38 years ago in the keystone case of *Eisner v. Macomber*, 252 U.S. 189 (1920):

> "We have no doubt of the power or duty of a court to look through the form of the corporation and determine the question of the stockholder's right, in order to ascertain whether he has received income taxable by Congress without apportionment. But, looking through the form, we cannot disregard the essential truth disclosed; ignore the substantial difference between corporation and stockholder; treat the entire organization as unreal; look upon stockholders as partners, when they are not such; treat them as having in equity a right to a partition of the corporate assets, when they have none; and indulge the fiction that they have received and realized a share of the profits of the company which in truth they have neither received nor realized. We must treat the corporation as a substantial entity separate from the stockholder, not only because such is the practical fact but because it is only by recognizing such separateness that any dividend—even one paid in money or property—can be regarded as income of the stockholder. Did we regard corporation and stockholders as altogether identical, there would be no income except as the corporation acquired it; and while this would be taxable against the corporation as income under appropriate provisions of law, the individual stockholders could not be separately and additionally taxed with respect to their several shares even when divided, since if there were entire identity between them and the company they could not be regarded as receiving anything from it, any more than if one's money were to be removed from one pocket to another."

This I believe correctly expresses the essence of the income tax law pertaining to corporation and stockholder as it has been inveterated in enactments of the Congress and in the interpretations thereof by the courts until this day. There now appear some unnatural disturbances on the horizon, however, which if not confined may serve to subvert the

deep-rooted concept of separateness between stockholder and corporation. We now have such things as partnerships and proprietorships which may elect to be taxed as corporations (Subchapter R), and corporations which may elect to be treated as partnerships in certain respects for tax purposes (Subchapter S). How really mixed up we can eventually get remains to be seen.

Conclusion

Except for borderline cases which fall on one side or the other only by the weight of fine seasoning, most unwanted or constructive dividends are avoidable by a sober consciousness that a corporation and its controlling shareholders so far, for the most part, are deemed to be separate taxpayers and that their dealings with one another will be measured by standards that should attend the dealings among strangers. Moreover, a full comprehension of the tax laws and regulations and the peculiarities of their application is most essential to insure that such dealings do not unnecessarily sprout seeds of retribution. Constructive dividends resulting from stock redemptions, particularly, often involve taxable amounts of the most serious proportions. Taxpayers contemplating stock reductions or divisive procedures of any kind without advice of counsel are truly putting their head in the lion's mouth.

To close on a small note, taxpayers who do find themselves with an unwanted dividend should at least assert their rights to the dividends received credit under Section 34 of the 1954 Code.

SOME METHODS OF VALUATION OF A GOING CONCERN

By John W. Stodder

If I were asked to state the single comment that I hope would register strongly with all of you in discussing methods of valuation of going businesses, I would ask that you never accept a rule of thumb or a mathematical formula as a means of answering the question, "What is it worth?" For example, I have been told that a company is worth 10 times earnings, or book value, or some figure derived from estimating the depreciated replacement value of the assets, or some figure related to annual volume. The remarkable thing is that occasionally one of those derivations can meet the valuation requirement of the circumstance, but I think it is coincidence.

Certainly there is no more inexact or contentious concept than that of value. The first necessary determination is the purpose for the valuation. Are we measuring a going concern so that we can consider a public offering of shares, or the outright sale of the business, or merger or consolidation with another company, or as a part of the process of determining the nature of the credit when arranging debt financing, or for the purpose of establishing the value of shares in an estate?

The second determination is that of whether you are to be an advocate or a judge, and whether it is a part of your responsibility to help effect a transaction between buyer and seller. Are you going to be asked to provide your valuation as a part of testimony or to help your client accomplish an objective? Or perhaps you will be asked for this valuation as a part of your client's appraisal of a course of action.

Perhaps I can persuade you to appreciate the likely frustration if you expect to uncover by diligent and intelligent study a price that would represent the highest paid and the lowest accepted under any conditions and at any particular time; or for that matter such a price under one condition and at one particular time. I think you must make serious inquiry and be prepared to defend your conclusion, but I do not know of any combination of formulae which would mathematically produce an exact answer; there is only reasonable knowledge and judgment.

Investment bankers are probably more concerned about the valuation problem than any other single factor in our business. Mistakes cost money. A sound conclusion can lead to possible profit for us, our clients and the investing public. In the matter of a public distribution of shares we have additionally a fiduciary responsibility which has caused us to refuse to offer

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stocks at prices we know the public will pay because of enthusiasm of the times. At other times we have had to take considerable risk and expend unusual effort to effect a successful financing at an offering price which seemed fair and provided sound value even though at first glance it appeared to be too high.

Investment bankers when commencing the task of valuing a going business for the purpose of developing a public offering of common stock must start with a basic appraisal of the company's management, its facilities, its financial position, its method of doing business, its market, its competition and the host of factors which make up a company.

To concentrate now on the method of securities valuation for purpose of their public sale, I would like to discuss some of the contextual factors which precede and become a part of the actual figure appraisal. We would ask, for example, these questions:

1. *What is the current status of the economy?* Its present outlook? Are there any significant pertinent political or government factors to be considered? etc.
2. *What is the nature of the industry?* Is it highly cyclical? Is it extremely competitive? Is it a well established industry or relatively new and still attracting strong additional competitors? Is it an industry financially easy to enter, or does it require high capital investment? etc.
3. *What is the position of the company in its industry?* Is it the leader or a small unit? Does it have some specific protection such as a patent, a natural resource, or location? Does it enjoy as good or better operating margins? How does its return on total assets or invested capital compare? etc.
4. *How capable is its management?* Does its management enjoy an excellent reputation? Does it make effective use of its resources? Does it have good personnel relationships? What is its labor situation and does it work well with its particular conditions? Has it trained successors? Does it have a sound corporate development and growth program? etc.
5. *What is the status of its ownership?* What are the long term objectives of the major owners? Is their attitude about the company sound and constructive? Would death or incapacitation necessitate sale of a major interest such that it might adversely affect the company's future? etc.

When determining the value of a going business for the purpose of valuing shares for a public offering, we must consider the specific financial condition of the company, the effect of the financing, the stock market, and the relationship of the company to the market. Of primary importance is the reliability of the company's audit reports and its method of reporting earnings. Further, are any of the earnings of a non-recurring nature or the result of some highly unusual condition? In effect, can the past earnings history be any sound guide to the future? Is it possible to soundly predict future earnings or appraise management's forecast?

In considering the financial condition of the company we are first concerned with its resources for operating on a sound basis over the long term. Is it adequately financed to survive adverse conditions without embarrassment and does it have sufficient resources to grasp opportunities that may lie ahead? Is it already making full use of its credit resources? Does it operate with minimum working capital and does it have large amounts of long term debt or senior equities outstanding? Will its continuing growth require additional invested capital? How soon is the need likely to occur? These questions obviously directly affect any basic assumptions as to earnings and dividends which become a part of a valuation.

There are, of course, different considerations when a company is selling additional shares to add funds to its capital as opposed to the sale of shares by present stockholders, or a secondary offering as we call it. In the first instance we have to determine the effect of the equity dilution and further estimate the time it will take for the new capital to show a return consistent with that earned by the present capital. Also we have to measure what effect can be expected on the ability to pay dividends. The specific price discount which may be occasioned because of the anticipated dilution probably cannot be isolated, but it is an important factor along with other considerations.

To further our discussion of valuation it is simpler to concentrate on the sale of existing shares. There are several relatively simple techniques to produce "numbers" which represent prices which then can be adjusted to compensate for various factors. The two most significant "numbers" to the financial public are "price times earnings" and "dividend yield." The former is simply the division of price by an earnings figure and the latter, the division of the annual dividend by the price. Another figure frequently used is the relationship of the market to the book value expressed as a percentage of the book value of the shares.

For example, let us assume Mr. Jones is the owner of 300,000 shares of Jones Manufacturing Company, a rather typical manufacturing business producing electric motors, industrial components, and a modest volume of consumer electrical products. The company has 1,000,000 shares outstanding which have a book value of $15.00 per share. The company earned during its recently completed fiscal year approximately $1,500,000 or $1.50 per share. I shall add further hypothetical facts as we proceed.

In the first instance, is the company already publicly owned? If there is a market, how active is it? Is the stock listed on one of the exchanges or does it trade in the over the counter market? If it trades on a regional exchange or in the over the counter market does it trade every day? More than one hundred shares per day? If it is an actively traded stock then we can give greater acceptance to the bid and ask which are quoted and perhaps that market quotation will largely restrict the latitude of our pricing. If it is lightly traded, then we probably would look to other factors to set our price. For example, we have actually successfully marketed shares at a price considerably in excess of the quoted market because other factors indicated that it was a sound procedure. That particular market was made by two trading houses in one city who probably traded not more than 100 shares a month, for not more than 5% of the stock was in public hands. The facts describing this limited market, by the way, were clearly set out in the prospectus.

If Jones Manufacturing Company is actively traded, is it the type of stock likely to interest institutional investors such as pension funds, mutual funds and insurance companies? If it is not actively traded, then the stock is likely new, not only to the institutional investor but also the individual. Some discount in price would be necessary to attract their interest. The size of the offering is also significant. Are enough shares to be offered so that there will be active trading or is such a large amount to be offered that a large investment

banking syndicate is required along with a real selling effort which may include larger commissions for securities salesman? The market considerations would also include an estimate of the popularity of Jones' industry as an investment and the specific standing and reputation of Jones within that industry.

To continue with our hypothetical Jones Company, let us assume that they have had a fairly good earnings record with earnings increasing from $950,000 during the year ending September 30, 1949 to $1,500,000 during the year ending September 30, 1958. During this period earnings have dipped slightly during the several recessions and were down $200,000 from the 1957 fiscal year. Simply as a matter of personal technique I would derive average annual earnings for the past two years, three years, five years and 10 years. I would do the same for its competitors and others which for one reason or another might be fairly compared. I would divide these earnings averages along with the current year, and the latest twelve months, into the various common stock prices of the other companies to derive a comparison of the price earnings ratios of the other companies. In our case Jones earned $1.50 this year, averaged $1.60 for the past two years, $1.53 for 3 years, $1.36 for 5 years and $1.16 for ten years. I would also index the earnings of the various companies during the period under review to determine the trend of earnings on a comparative basis. By inspection, it seems that shares of the other companies sell for approximately 11.5 times current earnings, 11.0 times the two year average, 11.6 times the three year average and so on. From a price earnings standpoint the million Jones shares are worth perhaps $17.00 per share. Jones is now prepared to pay and is paying 90 cents per share which is 60% of earnings and the comparative companies are also paying about 60%, providing a yield of about 5%. The comparative stocks are also selling at about 120% of book value and their invested capital is divided between debt, preferred stock and common in about the same proportions.

If we assume that Jones is now entirely closely held and that Mr. Jones wishes to sell all 300,000 shares, then we have several factors to consider. Is the capitalization of the company such that the number of shares outstanding will allow a popular price to be set on each share? Does the fact that he is selling all of his shares mean that he is retiring from the business and if so, what effect will that have on the business and on the investing public? What does the public think of the prospects for greater earnings in the future? Will the professional investors buy Jones stock? How much should the price be discounted to reflect that it is a stock new to the public?

In our example perhaps a public offering price of about 16¼ per share would be sound for that would be about 10.8 times current earnings and provide a dividend yield of about 5½%. It would be about 109% of book value.

Now to vary our example let us assume that Mr. Jones asked that we sell only 30,000 of his 300,000 shares. This amount would be too small to establish a sound public market by sale of the shares to the investing public at large. What are those shares worth? It would be necessary to find a highly sophisticated investor, or employees, or friends close to the

company's affairs and this is not always easy. If you were confronted with the problem of placing a value on 30,000 shares of this closely-held company you would allow a substantial discount to reflect the difficulty of selling the stock. It would not be unreasonable to cut the value by 25 to 35% for the buyer would expect a cheaper price because he will have a difficult time disposing of the shares or will have to wait until a public market is established.

To vary our example again, let us suppose the government, because of the death of Mr. Jones, is proposing to tax his estate and is preparing its concept of the value of the stock. If Mr. Jones was a vital factor in the management of the company, then that should be reflected in the valuation. If the future of Jones is not as sanguine as I have reflected in the discussion, the particular hazards should be discounted in the price. Certainly two elements can be discounted in the price; namely, the effect of having to sell a large block of stock at one time and the cost of handling the issue which could range from 4 to 12% plus legal and auditing expenses.

Let us vary our example again by assuming that Jones had $10,000,000 of long term debt outstanding which was due at the rate of $667,000 each year for the next 15 years and that annual depreciation was approximately $300,000 per year. The 90 cent dividend requires $900,000 per year. The cash flow during the past three years has been sufficient to meet the debt retirement schedule and dividend requirements. But it is likely that should earnings decline in any substantial amount, or it becomes necessary to invest the full amount of the depreciation in new facilities, the dividend rate would have to be reduced. Perhaps it would be sounder to assume that our 5½% dividend return should come from 40% rather than 60% if we are using yield to help us derive a value. In our example this would reduce the derived price from 16¼ to about $11.00 per share, perhaps too extreme for the case in point. The extent of senior securities is an important factor to valuation.

Perhaps Mr. Jones has asked that we value the company for purposes of selling or merging. It would be useful to have a concept of the investment value of the shares. In our example this price exceeded book value but if Jones had the same earnings but a book value of say $25.00 or a net worth of $25,000,000, then assets become a more important factor. An appraisal of the current market value of the assets apart from their integration as a going business would be helpful. A determination has to be made as to whether the company should be liquidated. If the assets exceed the market value of the business from an earnings standpoint, it is not likely a price close to asset value could be obtained unless the excess assets are cash equivalents or could be effectively used by the prospective buyer and represent to him a cheaper means of expansion. When a condition exists where earnings on assets are low, particularly in comparison with other members of the industry, it can become a difficult valuation problem which may be solved by a compromise asset and earnings power valuation.

Let us return to our assumption that Jones is earning $1,500,000 on a net worth of $15,000,000 with no funded debt or senior equity outstanding. We assumed that Jones was

worth about 10.8 times current earnings if we were to sell stock to the public. We desire to sell or merge the entire business. We are acting for Jones in setting a value. We can first determine whether in constructing an asking price we might ask for a fixed value security in addition to common stock so as to effectively leverage the common equity. For example, if Jones had $3,000,000 of 5% preferred stock outstanding it would reduce earnings for common to $1,350,000, but if they were valued at 10.8 times common earnings the common equity would be worth $14,600,000. If added to $3,000,000 of preferred, a total equity value would be $17,600,000 as compared to $16,200,000 derived by simply multiplying net earnings of $1,500,000 by 10.8.

Again acting for Jones, it might be determined that the most logical purchaser has common stock selling perhaps at 20 times current earnings and at twice book value. By exchange of common stock the purchaser could pay perhaps 15 times earnings or $22,500,000 at market value. The purchaser's share earnings and book value would actually be increased by the transaction. This is, of course, an important avenue of inquiry in setting a selling price which, notwithstanding advantages to the buyer, must bear a reasonable relationship to the particular outlook of Jones' company and his industry.

Naturally, if you are asked to establish a value for a purchaser you must separate the considerations of the seller's business independently of its value as part of the purchaser's company. It is obvious if it is not worth its independent value to the purchaser, then an advantageous transaction cannot be arranged, but if it has great incremental value to the purchaser, then the task becomes that of preventing the seller from capitalizing on this factor and persuading the seller to effect the transaction. It is a part of the valuation task, when advising a purchaser, to determine whether certain tax factors can become significant and useful persuaders. I have in mind the advantage of offering a closely held seller a marketable voting stock which, as you know, in a reorganization transaction can be taken without incurring immediate capital gains tax. In addition, under certain circumstances cash can be offered for assets when the price is at or below book value and the seller can become primarily an investing company and achieve a degree of liquidity in that manner. He might later merge this investing company with one which has a public market. There are seemingly an endless number of methods by which concepts of value can be changed and price objectives be accomplished.

I have attempted in this discussion not only to describe in a general sense some of the methods of valuation, but I have also suggested that, through these methods, different values might be achieved if certain financial factors are changed. I am hopeful that I have caused you to look at valuation from more viewpoints than that of an independent appraiser. If your assignment is to be a truly independent appraiser, then I hope that our discussion will cause an appreciation of the many means of achieving price and the need for extensive study before answering the question, "What is it worth?"

Events Subsequent to the Balance Sheet Date

By E. B. Wilcox

For more years than most of us can recall the problems of financial reporting that arise in connection with events occurring after the balance sheet date have had some attention from practicing accountants. In a case which attracted considerable attention many years ago, a corporation which had conducted a profitable general investment business for a number of years was acquired by a financier of somewhat doubtful reputation. He disposed of the investments previously held by the company and invested the proceeds in companies controlled by himself. Then he issued a prospectus inviting subscriptions to new securities of the company on the basis of results in the past under conditions which were entirely different from those existing when the prospectus was issued. Clearly an independent certified public accountant could not approve such financial statements in these circumstances.

The Securities Act of 1933 stimulated increased attention to this subject by granting the right to sue various persons including a certifying accountant in case that part of a registration statement purporting to have been prepared or certified by him contains, on the effective date, an untrue statement of a material fact or omits to state a fact required to make the statements therein not misleading. Several cases have been reported by the Commission, and perhaps the most notable is the release in the matter of the Colorado Milling and Elevator Company, issued in December, 1943. According to the release, this case is similar to the older one mentioned above. After the balance sheet date 90 per cent of the stock changed hands, a substantial investment portfolio was sold, and a dividend of some $7,000,000 was paid, mostly to the new owners. Then it was proposed to issue securities. Obviously the thing offered to the public, or which would have been offered but for a stop-order proceedings, was not the thing described in the financial statements.

For about twenty years the literature of accounting has indicated a growing interest in problems of this type. There have been some who felt that the certifying accountant should have no responsibility whatever related to anything that happened after the period covered by his examina-

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tion, but most accountants have not gone so far. In fairly obvious and extreme situations such as those just mentioned here, some duty to disclose them seems clear, but pending a more specific statement this area of responsibility was disturbingly vague. The literature referred to above reflects the seeking of a more definite understanding both as to what this responsibility is and on whom it rests. It culminated in Statement No. 25 by the Committee on Auditing Procedure of the American Institute of Certified Public Accountants, issued in October, 1954.

It should scarcely be necessary to say that the events requiring consideration are those which must be reflected or disclosed in order to prevent financial statements from being misleading. It seems equally obvious that information such as collection of receivables or bankruptcy of debtors, and settlement of tax or other claims, if acquired in time to permit its use, should be reflected in financial statements. This type of information relates to the presentation of financial position and results of operations for the period covered. There can, however, be events which are normally reflected in financial statements for the period in which they occur but which may be significant in connection with statements for a preceding period. Examples are changes in debt or capital structure, mergers, and acquisition or sale or casualty loss of substantial properties. These are sometimes called accounting events because they are of a nature ultimately reflected in the accounts. Another type of event, sometimes called non-accounting because it is not directly recorded in financial statements, would include such matters as labor troubles, loss of a principal customer, or marketing agreements. Information as to any or all of these various types of events occurring after a balance sheet date might be useful to the reader of financial statements.

The primary duty to disclose information necessary to make financial statements useful and not misleading rests on management. If, in the exercise of good judgment, any event occurring between the balance sheet date and the date of financial reports is deemed to affect materially the financial position or results of operations, it should be disclosed. In the exercise of this judgment it would be wise to keep in mind the extent to which results of historical operations may properly be regarded as an indication of earning power. Events of the type previously described as accounting events more clearly call for disclosure than do non-accounting events. Such general non-accounting events as widespread economic conditions or the threat of war are rather clearly not appropriate matters for disclosure in financial statements. If the certifying accountant knows of events which clearly do require disclosure, he shares in this responsibility.

Perhaps the most troublesome part of the subject is the extent of the duty of the independent certified public accountant to know of post balance sheet events. Obviously he cannot continue generally accepted auditing procedures into the post balance sheet period. However, he is responsible, at least under the Securities Act of 1933, for a reasonable investigation such as a prudent man would make in the management of his own property, whatever that means. Although this responsibility is statutory, it might be regarded as a professional one as

vell. It is from this standpoint that tatement No. 25 suggests the nature nd extent of a reasonable investiation. Primarily it seems that this hould be in the form of inquiries, nd it is certainly desirable that they e in writing and from responsible fficials and possibly from legal counel. Here familiarity with the organiation and personnel of a company an be most helpful in determining ow and to whom the inquiries should e directed. Other features of an inestigation include reviewing mintes and interim financial statements nd, in the case of a prospectus, a eview of its text and other pertinent ortions. It seems to be generally greed that scanning the books is not pt to be useful, but there remains a rge area of judgment in each case.

In order to put some limit on the eriod to be covered by the post balnce sheet date investigation, Stateient 25 suggests dating reports on ie date of completion of all imporant auditing procedures. This same ate would appear on all reports, in ases where a long form report or nancial statements filed with Form 0-K are actually prepared at a time fter the preparation of a report to shareholders. It follows that the auditor's responsibility would end as of that date. There are those who object to this on the grounds that it places undue emphasis on the significance of that date, but the recommendations of the Institute's Committee on Auditing Procedure seem to have found rather widespread acceptance. However there is also a widely held view that a prospectus should involve greater responsibility than should an annual report because the former involves an invitation to the public to invest funds whereas the latter is in the nature of a report on stewardship. Regardless of the merits of that distinction, the provisions of the Securities Act of 1933 give it some force. Obviously no investigation can reasonably be carried on or performed exactly up to the effective date of a registration statement, and various views informally expressed have indicated a tapering off of investigations as the effective date approaches. The courts have not been helpful on this point, but it seems probable that some standard of reasonableness may be expected when the auditor acts with care and in good faith.

OUR NEW RULE OF PROFESSIONAL CONDUCT

By J. F. Sullivan

On April 15, 1958 our Board of Directors presented to the membership a mail ballot on the new rule of professional conduct. In accordance with our By-Laws, in order to be counted, ballots must be received within sixty days after date of mailing to the membership, and a two-thirds majority of those voting (providing at least one-third of the members vote) is required for adoption. Upon the expiration of the required period of time, the Board of Directors announced that the new Rule 17 had been added to our Rules of Professional Conduct.

Rule 17, as adopted by the membership, reads as follows:

> "A member shall not permit his name to be associated with statements purporting to show financial position or results of operations in such a manner as to imply that he is acting as an independent public accountant unless he shall: (1) express an unqualified opinion, or (2) express a qualified opinion, or (3) disclaim an opinion on the statements taken as a whole and indicate clearly his reasons therefor, or (4) when unaudited financial statements are presented on his stationery without comments fulfilling the requirements of (3) above, disclose prominently on each page of the financial statements that they were not audited."

No doubt most members of the Society are aware of the development of this rule. However, at the risk of being repetitious, it is believed that it is worthy of review since the foregoing rule is the culmination of at least twenty years of effort.

In Statements on Auditing Procedure No. 1, issued in October 1939 under the title "Extensions of Auditing Procedure," it was stated that "The independent certified public accountant should not express the opinion that financial statements present fairly the position of the company and the results of its operations in conformity with generally accepted accounting principles, when his exceptions are such as to negative the opinion, or when the examination has been less in scope than he considers necessary. In such circumstances, the independent certified public accountant should limit his report to a statement of his findings and, if appropriate, his reasons for omitting an expression of opinion."

Eight years later in December, 1947 the Committee on Auditing Procedure of the Institute issued Statements on Auditing Procedure No. 23, entitled "Clarification of Accountant's Report When Opinion Is Omitted" in which it proposed an amendment to "Extensions of Auditing Procedure" designed to improve reporting practices. Because of the evident confusion

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hich ensued, the Statement was re-ised in May, 1949 and presented to ie members of the American Insti-ıte in November, 1949 and formally ɔproved. In December, 1949 the tatement was then reissued in TATEMENTS ON AUDITING ROCEDURE as No. 23 (Revised). he statement approved by the mem-ership of the Institute in 1949 read s follows:

"The independent certified public accountant should not express the opinion that financial statements present fairly the position of the company and the results of its operations, in conformity with generally accepted accounting principles, when his exceptions are such as to negative the opinion, or when the examination has been less in scope than he considers necessary to express an opinion on the statements taken as a whole. In such circumstances, the independent certified public accountant should state that he is not in a position to express an opinion on the financial statements taken as a whole and should indicate clearly his reasons therefor. To the extent the scope of his examination and the finding thereof justify, he may also comment further as to compliance of the statements with generally accepted accounting principles in respects other than those which require the denial of an opinion on the overall fairness of the financial statements. The purpose of these assertions by the accountant is to indicate clearly the degree of responsibility he is taking.

"Whenever the accountant permits his name to be associated with financial statements, he should determine whether in the particular circumstances, it is proper for him to (1) express an unqualified opinion, or (2) express a qualified opinion, or (3) disclaim an opinion on the statements taken as a whole.

"Thus, when an unqualified opinion cannot be expressed the accountant must weigh the qualifications or exceptions to determine their significance. If they are not such as to negative the opinion, a properly qualified opinion would be satisfactory; if they are such as to negative an opinion on the statements taken as a whole, he should clearly disclaim such an opinion. His conclusions in this respect should be stated in writing either in an informal manner, as in a letter of transmittal bound with the financial statements, or in the more conventional short-form or long-form report. However, when financial statements prepared without audit are presented on the accountant's stationery without comment by the accountant, a warning such as 'Prepared From the Books Without Audit,' appearing prominently on each page of the financial statements, is considered sufficient.

"It is not contemplated that the disclaimer of an opinion should assume a standardized form. Any expression which clearly states that an opinion has been withheld and gives the reasons why would be suitable for this purpose. However, it is not considered sufficient to state merely that certain auditing procedures were omitted, or that certain departures from generally accepted accounting principles were noted, without explaining their effect upon the accountant's opinion regarding the statements taken as a whole. It is incumbent upon the accountant, not upon the reader of his report, to evaluate these matters as they affect the significance of his examination and the fairness of the financial statements."

The foregoing statement was incorporated in the "Codification of Statements on Auditing Procedure," issued by the Committee on Auditing Procedures in 1951. In "Generally Accepted Auditing Standards," a special report by the Committee on Auditing Procedure prepared and published in 1954, the statement presented in the Codification was included by reference.

As a result of the foregoing, Reporting Standard No. 4 was adopted, which reads as follows:

"4. The report shall either contain an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an overall opinion cannot be expressed, the reasons therefor should be stated. In all cases where an auditor's name is associated with financial statements, the report

should contain a clear-cut indication of the character of the auditor's examination, if any, and the degree of responsibility he is taking."

For those who are interested, at about this time the Institute issued many examples of disclaimers which might possibly be used.

Subsequent to the 1957 annual meeting of the American Institute of Certified Public Accountants, Rule 19 was adopted by the membership by mail vote. The rule states:

"Rule 19—A member shall not permit his name to be associated with statements purporting to show financial position or results of operations in such a manner as to imply that he is acting as an independent public accountant unless he shall: (1) express an unqualified opinion, or (2) express a qualified opinion, or (3) disclaim an opinion on the statements taken as a whole and indicate clearly the reason therefor, and (4) when unaudited financial statements are presented on his stationery without his comments, disclose prominently on each page of the financial statements that they were not audited."

The new Illinois Society Rule 17 differs slightly in wording from the above AICPA Rule 19 in the portion following (4). The Illinois Society Rule 17 intends to make it clear that unaudited financial statements presented on a member's stationery must either include a disclaimer of opinion, with reasons therefor stated, or include a statement on each page that the financial statements were not audited. A member must be particularly careful not to mislead the reader as to the degree of responsibility the accountant assumes for the representations made in the unaudited financial statements presented on his stationery.

The significant point involved with respect to Illinois Society Rule 17 is that, under Article XIV, Section 5 of the By-Laws of the Illinois Society it is stated in effect that the rules of professional conduct adopted by the Society supplement the disciplinary clauses of the By-Laws. Article XV Section 1, states in effect that a member shall be liable to admonishment suspension from membership (not to exceed two years) or expulsion if he shall be held by the Board of Directors to have violated any of the By-Laws of the Society. Consequently, a violation of the Rules of Professional Conduct is a violation of the By-Laws.

Another point, perhaps less significant at the moment but certainly worthy of intense consideration, is the question as to what information or bulletins should be submitted to the membership for approval. Bulletin 23 was submitted for approval because Bulletin 1 was approved; however, the Codification of Statements on Auditing Procedure has not been approved by the membership, yet it incorporates Bulletin 23. Wouldn't it be well to consider this problem? Adoption by the membership at either the Institute or the Society level should give more force to the Bulletins. Yet, by following this procedure are we stifling the judgment of the accountant?

While this is being considered, remember Rule 17 is an integral part of our By-Laws and a member violating this rule is subject to disciplinary action by the Board of Directors.

WHAT'S IN IT FOR YOU?

By T. Melvin Holt

Many members may ask the ques-
on: "Why do I belong to the Illi-
ois Society of Certified Public Ac-
ountants?" There are certified pub-
c accountants who are not members
ho may ask: "What will I gain
rom membership in the state CPA
rganization?" For both groups of
PAs it is well to review occasionally
e Society's activities and values.

There are many things of value
rom one's professional organization.
or some members, one area of the
rganization is the most valuable one.
ther members have other interests.
here is something for all members,
nd you need to consider all sides of
e organization and its values in an-
wering these questions about society
embership.

RESTIGE

It is more than a prestige organiza-
on. To be sure, there is prestige val-
e in banding together into the only
rofessional society for certified pub-
c accountants in Illinois. Member-
ip indicates a CPA's professional
ature in the same manner as associa-
on memberships by members of oth-
r professions. The Society office an-
wers many inquiries relative to mem-
ership. The trend is toward recog-
ition of Society membership as in-
icating professional competence.

The geographical directory of mem-
ers in public accounting is widely
sed by banks, trade associations, and business and professional groups. The stature of a CPA is enhanced by his membership in his professional organization.

Another directory that has been distributed is a classified directory of members not in public practice. Some 30 per cent of the society members are not in the public accounting field. This directory classifies members by type of activity, such as manufacturing, educational, governmental or one of the other groups listed. The prestige of the CPA in his professional membership is very great for those who are not in public practice.

New Ideas and Technical Know-How

It is extremely difficult for one person by himself to keep up with every new accounting idea. This is true whether the question deals with taxes, accounting advances, or some other technical area. Realizing that one cannot keep up with everything by himself, the State Society feels that you can learn from others and exchange ideas, thus benefiting from resources larger than your own as an individual.

There are numerous meetings of a technical nature that are open and available to members. These include specific technical sessions for the society members alone. There is a two day tax seminar each year for the latest in income tax and other tax ideas. There are joint meetings with

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other organizations, which bring on broadening experiences through the exchange of ideas and the resulting acquaintanceships with those that are in related fields but not necessarily in the society membership.

An example of the high type of technical meetings is the advanced professional study conference co-sponsored by the Illinois Society of CPAs and Northwestern University in September, 1958. The theme of this three day conference was "The CPA as an Advisor to Management." The scope of this conference was so broad, and yet the details were so well covered, that the conference was valuable not only to public practitioners but to those in private accounting who might be even more closely related to management in an advisory capacity.

The society sponsors special courses in various fields, such as report writing, speech craft, accountants' legal responsibility, and others. The society works closely with the American Institute of Certified Public Accountants in making available to society members some of the special materials and courses developed in the Institute's continuing education program for CPAs.

The quarterly publication "The Illinois Certified Public Accountant" has various technical articles of interest. The newsletter and other bulletins sent by the society office are intended to keep members up to date regarding changes that may affect the work of members.

The society publishes some valuable special booklets. A recent one that has had much favorable comment is "The Disposition of a CPA's Practice." On any particular special problems that a member may have, concrete help is available as near as your telephone. The society is a cooperative activity, and your cooperation with the society will enlarge the cooperation of the society with you.

The Value of Your CPA Certificate

You can be proud of your certificate as a certified public accountant only as long as organized effort by the professional society of CPAs in the state preserves its integrity and essential usefulness to the public. The society is always on the alert to protect the public and the profession in all legislation affecting certified public accountants.

The society continually supports high standards of professional conduct. The society's rules of professional conduct or "code of ethics" is assurance to the public that society members are proceeding on a highly professional basis.

The society provides a great deal of public information regarding the profession. By using the media of television, radio, newspapers, and meetings, the public is continually being informed of the CPA and his work. The society has presented a number of instructive and informative programs over Chicago's educational television Channel 11.

Someone has compared society membership with your automobile insurance. You do not hesitate to maintain the insurance policy on your automobile, and, in fact, one would be foolish not to do so these days. In a similar way, your membership in the state society helps to insure, or maintain, the value of your CPA certificate.

Fellowship

How many certified public accountants do you know? How many CPAs do you know well enough to discuss

roblems with? If the answers to ese two questions are comparatively w in numbers, then you have a real ed for more society activities.

Many friendships and business asciations have begun through society embership. Committee service prodes a number of new acquaintances, id lasting associations have been ilt by working together on some parular subject.

The three day annual meeting will oaden your acquaintance on a stateide basis. Other meetings and events so will widen your personal contacts id your outlook.

The opportunity to serve on comittees, to work within the chapters or those outside the Chicago area) id to work with the board of direcrs, is open to all members. Committe work is not ordinarily a burden, id most of those who do work on soety committees feel that the benefits r outweigh the small amount of time ent on a particular activity.

ONEY IN YOUR POCKET

There are special benefits to memrs that can result in financial gain well as in the other tangible and tangible benefits that have been menoned.

The insurance program is quite ried. Several types of personal inrance are available in the society's oup policies, including accident, sability, group hospitalization, maj medical insurance, accountant's ofessional liability, and others.

One member stated that he had been arching for a reasonably priced ajor medical insurance for himself id his family for years, and the soety's group plan was the first such surance that seemed to be worth irchasing. Premiums on the various group plans are much less than comparable coverage on an individual basis.

Practitioners find invaluable the accountants' liability insurance available to members. Too often the need for this type of insurance is not recognized until it is too late. Through your society, this insurance can be had now.

The library arrangement with Northwestern University's Joseph Schaffner Library of Commerce, at the Chicago campus, provides free access to all types of technical accounting information. This library privilege is particularly helpful to members who do not otherwise have consultation services readily available.

The society's Benevolent Fund is maintained to aid those who encounter extreme financial hardship, or for the families of deceased members when there is a hardship situation.

The society's technical question and answer service is of great value, and, in conjunction with the available library privileges, provides a complete source of information for any inquiry of almost any sort that may present itself.

WHAT'S IN IT FOR YOU?

What can the Illinois Society of Certified Public Accountants do for you? This report has named some of the numerous tangible and intangible benefits. For many members, one or a very few of these benefits are of more than enough value to justify continuing membership in the society.

In addition, there are further invisible intangibles that accrue because of continuing society membership. It can be said that a member gets out of his membership what he puts into it.

(Continued on page 47)

TAX COMMENTS

Conducted by the Committee on Taxation of the Illinois Society of Certified Public Accountants

COOPERATIVES AND PATRONAGE DIVIDENDS

The 1st Session of the 86th Congress is currently considering legislation which, if enacted, will at last accord the Patronage Dividend the full legal recognition it deserves. The Treasury Department has submitted proposed legislation designed to insure the ultimate payment of a single tax on cooperative income. After years of relying on administrative fiat and conflicting court decisions, the Treasury Department is now proposing the addition of an entirely new subchapter to the Code, "Subchapter T—Tax Treatment of Patronage Allocations."

When one stops to consider that the patronage dividend was already a well established principle in the administration of cooperatives long before the adoption of the Sixteenth Amendment, it is difficult to understand why new legislation is necessary in 1959. However, closer scrutiny soon discloses that the patronage dividend has always been somewhat of an enigma, innocuous appearing on the surface but lending itself readily to innumerable interpretations. The previous reference to conflicting court decisions refers not so much to direct contradictory findings, but rather to the numerous theories advanced by the various courts to arrive at the same finding.

Back in 1918, some long-forgotten Treasury official issued the first ruling[1] on patronage dividends to the effect that such periodical refunds by cooperative societies tended to reduce the net income of the organization. Since the Revenue Act of 1916, in force at that time, made no mention of patronage dividends, he justified this finding by adding the following statement: "This ruling is in accordance with settled practice in the administration of the income tax laws adopted because the real purpose of such organizations is to furnish goods at cost."

Thirty one years later a District Court in Iowa cited 185 court decisions, 19 Treasury Department rulings, 35 law review articles, and various textbooks and other publications to arrive finally at the same conclusion.[2]

In the light of our present knowledge of the administration of the income tax laws it seems ludicrous to think of any practice as being the "settled practice" back in 1918. However, as applied to the tax treatment of patronage dividends, this only emphasizes the fact that the taxation of patronage dividends is much more complicated than it appears to be on the surface.

Although many factors have contributed to this confusion, the one factor that stands out above all others is

[1] T. D. 2737, June, 1918.

[2] Farmers Cooperative Co. v. Birmingham 8 F. Supp. 201 (1949).

E. J. Farrell, who is a partner in the firm of Gauger and Diehl, Decatur, prepared the comments for this issue.

e complete absence for many years any statutory authority to either clude or deduct these allocations. s a result, each cooperative had to ly on its own individual facts and ery court had to rationalize its desion on some theory of basic propty rights. In an attempt to remedy is situation, the Revenue Act of 51 touched briefly on patronage divends, but a series of subsequent urt decisions has rendered this legation largely ineffective.

Another factor to be considered is e multitude of taxpayers concerned th patronage dividends. Figures mpiled by the National Federation Grain Cooperatives [3] show that durg 1956-57 there were 9,872 farm operatives in the United States emacing a total membership of 7.6 illion patrons with a business volne in excess of $10 billion. In Illiis alone there were 521 farm coopatives, with 550,000 members, doing business volume of $600 million. ith an estimated national farm popation of 4.7[4] million families it is vious that many farmers belong to ore than one cooperative while the mber of farmers who do not belong at least one cooperative would be ry limited. Furthermore, many her types of businesses outside the ricultural field have found the coopative to be most effective in meeting odern competition.

Not the least of the troubles besetg the equitable taxation of co-ops the belief in many quarters that the op is an evil monster spawned sole- for the purpose of avoiding taxes. is, of course, is not true as the recds show that the first farm coopera-e was organized more than 100 years ago. In 1910 there were more than 1,400 [5] farmer-owned grain elevators in the United States. Nevertheless, any discussion of the taxation of cooperatives usually generates intense feelings and on at least one occasion resulted in a full-scale Congressional investigation.[6]

Congress has always believed that cooperatives should be entitled to some degree of tax exemption, and every revenue act from 1913 down to 1951 made some provision for the complete exemption of co-ops. Since the requirements for complete exemption were quite rigorous many co-ops chose to forego this exemption rather than submit to the crippling restrictions on their operations. This split cooperatives into two major groups, the exempt co-ops and the non-exempt co-ops. The exempt co-ops had to show only that they met the tests of exemption to be completely free of tax while the non-exempts had to file regular corporation returns and compute taxable income under the regular provisions of the Code. Since both groups paid patronage dividends there was a tendency to look to the exemption provisions for the authority to deduct these allocations. Failing to find relief there, the non-exempts had to fall back on the other sections of the Code.

The general rule of taxation is that the taxpayer who claims a deduction must point to some section of the Code which authorizes the deduction. With no statutory authority for a deduction, the first presumption is that the patronage dividend is like any other dividend and therefore should not be considered in the computation of taxable income. The first published rul-

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Coop. Grain Quarterly—Volume 17, Number 1, ;e 6.

Ibid. page 5.

[5] *Ibid.* page 99.

[6] House Report No. 1888, 79th Cong., 2nd Sess. (1946). "Competition of Cooperatives with Other Forms of Business Enterprise."

ing[7] neatly side-stepped this issue and did not purport to be issued under any specific section of the Code nor did it attempt to determine whether the amounts refunded were deductions from taxable income or items that should have been excluded from the income of the organization from the beginning. It merely stated that such refunds "tended to reduce the net income of the organization." Subsequent rulings[8] were more definite and were issued under the sections defining what was to be included in income and what could be excluded.

The courts had more difficulty in justifying the exclusion of these refunds from the income of the cooperative. Some courts adopted the theory that the co-ops were merely agents for patrons, and as in any other agency relationship the income was taxable to the principal and not to the agent. Other courts looked at the co-ops as trustees acting in a fiduciary capacity for their patrons. Another theory considered these organizations as being similar to partnerships and therefore taxable in a similar manner.[9]

On the other hand, some courts adopted the so-called "command of income" theory and held that even where the cooperative had issued certificates of allocation to its patrons, so long as the reserve against which the certificates were issued was subject to the command or control of the cooperative, there could be no exclusion from the income of the cooperative.

In some cases the cooperatives were taxed on earnings despite pre-existing obligations to refund excess earnings to patrons on the grounds that these agreements were anticipatory assignments of income and therefore taxable to the cooperative rather than to the assignees.

The Revenue Act of 1951[10] attempted to end some of this controversy by repealing the section granting complete exemption for some farm cooperatives, and adopting new sections for these formerly exempt associations providing specific deductions for limited dividends on capital stock, amounts allocated from income not derived from patronage and patronage dividends.[11] It is interesting to note that this section provided that the deduction for patronage dividends was to be taken into account in computing taxable income in the same manner as in the case of a cooperative organization not previously exempt. Since there existed no previous statutory authority for the deduction of patronage dividends by the taxable cooperatives, this expression of the will of Congress was interpreted as Congressional approval of the long standing administrative rulings on patronage dividends.

This legislation also settled the much litigated question of whether or not there had been an allocation of patronage dividends. It provided that patronage dividends were deductible whether paid in cash, merchandise, capital stock, revolving fund certificates, certificates of indebtedness, letters of advice, or any other manner that disclosed to each patron the dollar amount of his dividend.

The Commissioner, in an attempt to button up any loopholes, issued regulations[12] providing that any such certificates or letters of advice were taxable to the recipients when re-

[7] T. D. 2737, June, 1918.

[8] I. T. 3208, 1938-2 C B 127.

[9] See Farmers Cooperative v. Birmingham, 86F. Supp. 201, for a complete discussion of these theories.

[10] Sections 313 and 314, Revenue Act of 1951.

[11] Section 101 (12), IRC1939; Section 522 IRC 1954.

[12] Regs. 111, Section 29.22 (a) 23.

[rece]ived to the extent of their full face [a]mount. Since most of these certifi[c]ates had no immediate cash value, [li]tigation soon developed by patrons [r]esisting the assessment of income tax [o]n these paper allocations.

The Carpenter[13] case, decided by [th]e Tax Court in 1953, held that a [c]ash basis taxpayer received income [o]nly to the extent of the fair market [v]alue of the certificates. The Com[m]issioner argued that since the coop[e]rative had been allowed a deduction [f]or the face amount of the certificate, [th]e same amount should be taxable to [th]e patron. The Court pointed out [th]at the cooperative and its patrons [w]ere different taxable entities and it [d]id not necessarily follow that what [th]e cooperative excluded from income [w]as automatically income to its pa[tr]ons. This decision was affirmed by [th]e Court of Appeals for the Fifth [C]ircuit [14] in 1955.

In 1957, in Long Poultry Farms, [I]nc.,[15] the Tax Court held that an [a]ccrual basis taxpayer must report [th]e face amount of a patronage allo[ca]tion when the only real uncertainty [w]as the time of payment. The tax[p]ayer appealed to the Court of Ap[p]eals for the 4th Circuit.[16] The Com[m]issioner relied on his regulations[17] [w]hich specifically stated that such div[id]ends were taxable to the recipients [a]t their full face amount. The Com[m]issioner maintained that in 1951, [w]hen Congress granted the right to [th]e deduction to the cooperatives, they [r]elied on testimony before the com[m]ittees of Congress that such divi[d]ends would be returned for taxation [b]y the recipients.

However, the Court of Appeals reversed the Tax Court and pointed out that, while Congress had granted the right to the deduction to the cooperatives, they had left the matter of taxing the dividends to the recipients to be dealt with by existing law. Since the certificates in question had no market value and were payable only if and when the directors should so decide, the Court held that they were too contingent to be properly accruable as income in the year received. The Court went further and struck down the Commissioner's regulation in the following words:

"But to the extent that this regulation is contrary to existing law or attempts to tax as income what is not income under law, it is, of course, void and of no effect. To require the inclusion in income of contingent credits such as are here involved would be to require the patrons of cooperatives to pay tax upon income which they have not received, over which they have been given no control, and which they may never receive. Apart from the question of constitutionality of such a requirement, which would be a serious one, it is a safe assumption that Congress never intended to impose upon the patrons of cooperatives the hardship and burden which the taxability of these contingent credits would involve."

Early in 1958, the Commissioner announced[18] that he would follow the principles set forth in the Carpenter and Long Poultry Farms cases and revise his regulations accordingly. Since practically all patronage certificate allocations are contingent in nature and very few have any real market value, the cooperatives will escape taxation by making contingent allocations and the patrons will es-

(Continued on page 42)

13 20 T C 603.
14 219 F. (2d) 635 (C.A. 5, 1955).
15 27 T C 985.
16 249 F. (2d) 726 (C.A. 4, 1957).
17 Regs. 118, Section 39.22 (a) 23.

18 T.I.R. No. 69, dated February 14, 1958.

HIGHLIGHTS ON AUDITS OF ILLINOIS MUNICIPALITIES

By W. A. Froehlich

Much has been written about accounting principles and auditing theory and procedures applicable specifically to cities and villages, including the excellent publications of the National Committee on Governmental Accounting, and no useful purpose would be served if a paper such as this were merely to duplicate such material. Conversely, however, there appears to be a need on the part of public accountants, especially those who are relatively inexperienced in the field of municipal auditing, for material concerning the "what," "why," and "how" of factors peculiar to municipal accounting.

It is the intent of this article to set forth in brief form the essential elements and peculiar characteristics of municipal audits that must be understood by the independent public accountant if he is to perform a satisfactory audit. With this point of view in mind, the material following is presented under three major sections: (a) Legal Fiscal Requirements of Illinois Municipalities, (b) The Engagement, and (c) Special Characteristics Peculiar to Municipalities.

Legal Fiscal Requirements of Illinois Municipalities

It is essential that public accountants interested in performing audits for Illinois municipalities be thoroughly familiar with the laws which pertain to the fiscal affairs of cities and villages. The "Cities and Villages Act" of the Illinois statutes and the "Municipal Audit Law" set forth substantially all of the various rules, regulations, powers, restrictions, limitations, and the like, under which municipalities operate. While it is recognized that the accountant should not attempt to interpret the law, it is necessary for him to be familiar with the accounting aspects of the law in order for him to perform an intelligent audit of an Illinois municipality.

Not only must the accountant be well informed about the accounting requirements as contained in the Illinois statutes but, in addition, he must have an adequate understanding of the accounting requirements contained in the ordinances of the municipality for which he is performing audit services.

Therefore the audit program must necessarily include audit procedures which will reveal compliance or possible non-compliance with the applicable legal requirements. In this connection, the accountant must be aware that legal requirements of the specific city or village *always* take

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ɔrecedence over what otherwise might ɔe considered sound accounting practice.

Гhe Engagement

In contemplating an audit engagenent for a municipality, the accountınt would be well advised to give ·areful consideration to the following mportant factors:

Гhe Type of Audit He Is to Perform

The importance of this factor canıot be overemphasized for, unless the ıature and scope of the audit are ·learly set forth and understood by ɔoth the accountant and his client, erious misunderstandings can arise ıs to the auditor's responsibilities.

In this connection, considerable con'usion exists in the minds of some nunicipal officials as to the definition ınd scope of an audit. This confusion s not lessened by the numerous defiıitions and types of audits presented n various publications issued for the ɔenefit of fiscal officers. The greatest ırea of confusion, however, exists in lifferentiating between a "general" ıudit and a "complete or detailed" ıudit. In the former, the audit in'olves substantiation of financial tatements and accounts by means of ests, while the latter type of audit ·ntails examination of *all* items enterng into accounts and transactions.

It is obvious that if, in a given ituation, a municipality desired a omplete or detailed audit, sampling echniques and test-checking of transıctions by the auditor would not meet he requirements of the engagement. Conversely, if the auditor assumed hat he was to perform a complete ıudit of all transactions of all funds ınd so employed his time, it would ıppear that he might have difficulty n collecting his total charges if the municipality was under the impression that generally accepted auditing procedures and standards were to be employed. Since the fee arrangement is generally based upon the scope of the proposed engagement, if the exact nature of the examination is not clear an unsatisfactory fee realization may result.

In order to define more precisely the extent and scope of the examination, it is suggested that consideration be given to the following checklist:

(1) Determine the specific fund or funds to be audited.
(2) Determine the fiscal period or special period to be examined.
(3) Briefly review the system of internal control, accounting practices, and the condition of the records in order to determine the degree of reliance that may be placed thereon and the extent to which sampling techniques may properly be employed.
(4) Determine the basis of accounting employed: cash, modified cash, or accrual.
(5) Determine the form of government adopted by the municipality.
(6) Determine the existence of special services and utilities operated by the municipality and whether or not they are to be included in the scope of the examination.
(7) Determine the audit requirements as set forth in the Municipal Audit Law.

The Audit Proposal

Upon completion of the suggested preliminary steps, the accountant should then be in a position to develop and submit an intelligent audit proposal and, if required, an estimate of the cost of performing the engagement. The proposal should be in writing and should set forth in unambiguous language the exact extent and scope of the contemplated examination. Suggested elements for incorporation in a proposal, though not all inclusive, are listed briefly as follows:

(1) Period to be covered.

(2) Funds to be included, naming specific funds to be excluded, if applicable. Normally, if none of the funds are to be excluded, the proposal letter would simply state "all funds are to to be audited."

(3) Type of examination, that is, *limited* (restricted as to certain areas, cash receipts and disbursements only, review of accounts, and the like), *complete* or *detailed* (as discussed heretofore), *general* (based on testing and sampling techniques and the employment of other generally recognized auditing procedures).

(4) Type of report to be rendered—short or long form, comments on internal control and accounting practices of the municipality, and the like.

(5) Responsibility of the auditor and restrictions on rendering an opinion, if applicable, and the areas of possible denial of opinion; for example, unsubstantiated opening general ledger balances, non-conformity with procedures prescribed by statute or local ordinances.

(6) The estimated cost and, if deemed necessary, arrangements for payment.

In addition, it is highly desirable, under certain circumstances, to make provision for possible extension of audit procedures, where, for example, internal control appears to be highly unsatisfactory or irregularities are apparent. Such provisions generally require agreement on the part of both parties, including adjustment of the fee arrangement, before the extended audit procedures are put into effect.

Upon acceptance of the audit proposal by the municipality, the auditor should follow to see that proper approval and authorization is contained in the minutes of the council, or other authorized body, and to determine that funds have been appropriated to cover the cost of his services. Without the latter two actions being taken by the municipality, especially if controversies arise, the auditor might have difficulty in collecting his fee.

Due to the political nature of the form of government generally found in all Illinois municipal corporations, requiring the "management" to be elected by the citizens of the municipality, it is understandable that the elected officials have varying business experiences, ranging from those of the housewife to the business executive. Coupled with the ranges in exposure to good business practices, including the understanding or lack of understanding of accounting concepts, it is generally true that some turnover in officials takes place from election to election.

These two factors become quite important to the independent auditor for, while requirements of the various statutes and ordinances might appear to have been followed, the manner of accounting for the municipality's resources and obligations could have been improper, due to ignorance, incompetence or other deficiences of the elected body and/or employees. It is, therefore, essential in commencing the engagement that the auditor make a comprehensive review of the system of internal control and accounting practices employed by the municipality.

The second step in the audit program generally should be the inspection of *all* applicable ordinances and minutes relating to fiscal matters for the period under review so that knowledge is had of all established or authorized financial requirements and transactions for subsequent verification and tracing into the records.

In this latter connection, it is important to note that many revenue bond indentures provide for special accounting treatment of revenues derived from the activity for which the

bonds were issued. Such provisions generally require that certain amounts be set aside monthly or periodically into "Maintenance and Operation Accounts," "Bond and Interest Sinking Fund Accounts," "Bond Redemption Accounts," "Special Reserve or Surplus Accounts," etc. It is absolutely essential that the auditor read such indentures carefully so that he is thoroughly familiar with the various provisions contained therein.

As to auditing techniques to be employed in the engagement as a whole, generally recognized auditing procedures should be used to the extent deemed necessary in the circumstances. As stated previously, excellent published material is available on this subject. However, as to accounts and factors peculiar to a municipality, a few highlights on such matters are presented in the final section of this article.

Special Characteristics Peculiar To Municipalities

Definition of a Fund

In Illinois, the term "fund" as used in the governmental accounting sense can pertain to one or more of the following: (a) A special tax levied for a particular purpose or activity, (b) Activities or accountabilities created by action of the corporate authorities of the municipality itself, (c) Accountabilities which are clearly indicated or required in the opinion of the professional accountant in order to account properly for assets, liabilities, and transactions of a special activity. Thus a fund may be both a sum of resources and an independent accounting entity, providing for a self-balancing group of accounts consisting of the various assets, other resources, liabilities, obligations and available balances or deficit of the activity. In addition, accounts are maintained to permit identification of revenues and expenditures and receipts and disbursements in the fund to which they apply.

Appropriation and Tax Levy Ordinances

In Illinois municipalities all expenditures must be provided for in a legal instrument called an "Appropriation Ordinance." A budget is generally prepared by the Manager and Council in Council-Manager cities or the Finance Committee in Mayor-Council cities, taking into consideration each function, activity and object of expense. The budget is then drafted into an appropriation ordinance, setting forth the source of revenue from which each expenditure is to be met, either from tax levies or from other revenues, such as licenses, fees, fines, parking meter receipts, etc., or from both. Upon being duly adopted, the appropriation ordinance becomes the legal authority for incurring encumbrances or expenditures.

Immediately fellowing the development and adoption of the appropriation ordinance, a tax levy ordinance is prepared for filing with the County Clerk, setting forth by funds the various items to be met from tax levies. In this connection, it must be recognized that maximum tax rates exist and even though a municipality develops a tax levy ordinance in excess of its tax extension rate, it will only receive the legal maximum.

The auditor should review the two respective ordinances and, during the course of his examination, should determine whether expenditures have or have not been made in conformity therewith. Proper disclosure should

be made in the auditor's report where nonconformity has been noted.

Taxes Receivable

In the state of Illinois, real estate and personal property taxes are not placed in collection until approximately 14 months after assessors have established property valuations. Accordingly, at the end of each municipality's fiscal year, regardless of which month of the year was selected for the end of the fiscal period, a receivable exists. This is true whether the municipality is on the cash or accrual basis. Such receivables are not collected 100% for, based on previous tax collection experience, it is known that generally a certain portion of the tax levy will not be collected in the normal way and, in addition, certain allowable fees and collection costs are retained by the tax collection officers. For those municipalities maintaining their records on the accrual basis of accounting, this situation gives rise to the establishment of reserves for loss and costs on taxes receivable. Further, in this connection, it is important to note that the assessment made in the "levy year" does not give rise to a specific receivable from taxpayers until the following year. In general, the adoption of a tax levy ordinance establishes a maximum total to be charged to property owners; however, until rates have been determined and taxes extended, the individual charges to taxpayers are not known. Hence it is usually necessary to adjust the amounts recorded as tax levies receivable (if the accrual basis of accounting is used) when final extensions are completed.

When a municipality is on the cash basis of accounting, it normally picks up the net amount of the proceeds, as remitted to it by the tax collection officers, by debiting cash in bank and crediting revenue from tax collections. Conversely, when a municipality operates on the accrual basis of accounting, it normally would debit cash in bank for the net proceeds of the remittance, credit taxes receivable for the gross amount of the tax collection and charge off the difference, representing fees and costs, to a reserve for loss and costs account.

Procedures for verification of the total tax levy, taxes collected and remitted, costs of collection and taxes held in reserve by the County Collector, would be by direct correspondence or visit to the offices of the County Clerk and the County Treasurer. In addition, collections applicable to prior years' taxes would be reviewed and verified in the same manner.

Tax Anticipation Warrants

In connection with the preceding comments, a logical question could arise, "If the municipality does not receive collections on its tax levies until the following year, how can it meet its current operating costs?" In general, the Illinois statutes provide for this situation by empowering the municipality to issue and sell tax anticipation warrants to the extent of 75% of its tax levy. Certain special provisions apply to the issuance of general corporate tax warrants when a municipality has a working cash fund.

Such warrants are redeemable only from collections of the tax levy against which they were drawn. If collections prove insufficient to cover the outstanding tax anticipation warrants, payment *cannot* be made from collections of any other tax levy year. In addition, it is important to note that interest payments applicable to tax

nticipation warrants cannot be included in the tax levy ordinance, even hough payment *can only* be made rom collections of the applicable tax evy.

Audit procedures would generally e identical to those employed in the erification of outstanding bond in-ebtedness.

It is of interest to note that some unicipalities have discarded the use f tax anticipation warrants in favor f legal establishment of working ash funds.

lbatement of Tax Levies for Bond ndebtedness and Interest Liability

As was stated previously, each ele-ent of expense to be incurred during he ensuing year, to be met from roperty tax revenues, must be pro-ided for in the tax levy ordinance. ccordingly, for each bond issue, pro-ision must be made in the initial year f issuance to levy taxes to cover the eriodic redemption of the bonds and he semi-annual interest payments uring the life of the bond issue. evies for debt service are generally ade from one to two years in ad-ance of requirements. In the event hat bonds are authorized and not sold r are redeemed in advance of the riginally scheduled maturity, taxes future periods should be abated, oth as to principal and interest equirements. The auditor should heck to see that all abatement matters ave been properly computed and ecorded.

'ixed Assets

Some municipalities, exclusive of ose operating utilities, do not main-ain fixed asset funds. In view of the act that the cost of such items had een appropriated for and paid rough bond issues, tax levies, etc., the expenditures were treated as any other type of expense. This treatment appears to be in conformity with the law; however, good business practice would require fixed assets to be set up in a separate fund, so as to have proper accountability of such expenditures. This is especially true of movable assets such as automobiles, typewriters, desks, other office equipment, etc., for, without some means of control, including a periodic inventorying of such assets, improper use or loss of municipal property could occur. In addition, adequate records of fixed assets would provide important information for use in:

(a) Capital improvement programming
(b) Insurance programming
(c) Property control

Encumbrances

Due to the fact that all expenditures must be provided for in the appropriation ordinance applicable to a specific fiscal year, it is necessary that some method of control be established to insure that appropriations are not overspent and that provision is made for outstanding obligations. This can be accomplished through the the establishment of an encumbrance system wherein obligations in the form of purchase orders, contracts, etc. are reserved against the applicable appropriation accounts.

Basically, an encumbrance merely earmarks the appropriation so that the amount encumbered can not be used for anything else until the actual expenditure has been determined and charged against the appropriation. Through such a system the unexpended balances in the various appropriation accounts can be readily determined. When the obligations are

paid or set up as an actual liability they cease to be encumbrances.

The independent accountant should be well informed in the operating mechanics of the encumbrance system and in addition should be familiar with the development, adoption and use of appropriation ordinances.

The foregoing highlights are indicative only of the special nature of certain phases of municipal accounting and auditing and, in a limited way, suggest the need for careful review of the various aspects involved in the audit of the records of an Illinois municipality.

Tax Comments

(Continued from page 35)

cape taxation for many years and possibly forever.

It is this situation which the proposed new Subchapter T should remedy. The proposed legislation will allow a deduction to the cooperative only if paid in cash or in the form of a document with an unconditional promise to pay the face amount plus 4% interest within three years. The patron will be required to report only the amount of cash received in the patron's taxable year of receipt of such cash. The statute further provides that if the cooperative fails to pay within three years then the deduction shall not be allowed for any year and the statutory period for deficiency assessments is extended so that the year in which the deduction was claimed can be adjusted.

This appears to be fair and equitable treatment for both the cooperative and its patrons. Although representatives of the cooperatives have already objected vehemently to the three year requirement, this appears more than generous when it is compared to the requirement imposed on the building and loan associations. These associations are allowed deductions for dividends to members only if actually paid in cash or made available for withdrawal during the taxable year.[19]

Regardless of its final form, this legislation represents an important step in the taxation of patronage dividends. After years of neglect, the patronage dividend has been recognized as a unique problem worthy of a special subchapter. This cannot help but be a great aid in the orderly administration of the income tax laws.

[19] Section 591, I.R.C. 1954.

The Illinois CPA Examinations November 1957 and May 1958

By D. A. Grossman and Zella Hall

While not mentioned by the World lmanac as being important dates, ovember 6, 7, and 8, 1957 and May 4, 15, and 16, 1958 were red letter ays for a good many men and women hroughout the United States for, on hose dates, CPA examinations were eld in the forty-eight states and everal territories. These men and omen had devoted many months in reparing for this important examnation which, if passed successfully, ualifies the candidate to receive the oveted CPA certificate.

In Illinois, 990 individuals sat for he two examinations of November, 957 and May, 1958. This represented decrease of 79 over the two coresponding previous examinations in his state.

In 1903 the Illinois legislature assed the first statute providing for he issuance of the CPA certificate in he state. In this statute the responibility for administration of the law as delegated to the University of llinois. Since then this original law as been amended several times, the resent statute being passed in 1943. he responsibility of administering hat portion of the law which deals ith the issuance of the CPA certifiate is delegated to the University of Illinois, while that portion dealing with the registration of *public accountants* is administered by the Department of Registration and Education in Springfield. In the fifty-five years since the first CPA law was passed, the University has awarded 7,031 CPA certificates.

To administer the University's responsibility under the law, the President of the University has appointed a Committee on Accountancy. To conduct the examinations and grade the papers, the University Board of Trustees has appointed a Board of Examiners consisting of two certified public accountants and one member of the Illinois Bar. Each member of this Board serves three years on a rotating basis, a new member being appointed each year.

For a good many years the Illinois Board has used the uniform examination questions prepared by the American Institute of Certified Public Accountants. In recent years the Illinois Board of Examiners has also used the uniform advisory grading service provided by the American Institute. Papers are graded in the first instance by the Institute Board, these grades are checked by the Illinois Board, and then the marks for

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each candidate are certified to the University of Illinois Committee on Accountancy. Since the examination papers show only the number of the candidate and not his name, his identity is not known to the Board of Examiners and it is only after the papers are completely graded that the results are identified with the individuals by name.

Of the 990 candidates sitting for the two examinations under present consideration, 260 were successful in qualifying for the certificate:

	November 1957	May 1958
Passed in all subjects at one time	80	45
Passed final subjects under the conditional rule, having previously obtained passing marks in other subjects	81	54
Total successful candidates	161	99

In addition to those candidates who pass the subjects necessary to qualify for the certificate, there are others whose standing on the examination is good enough to merit "condition status" as provided by the law. The Illinois statute provides that a candidate may be "conditioned" if he meets any one of the following three requirements:

(a) Passes (75% or higher) in the three sessions of Accounting Theory and Practice and attains grades of at least 50% in Auditing and Law, or
(b) Passes in Auditing and Law but fails other portions of the examination with a grade of not less than 60%, or
(c) Passes the three sessions of Accounting Theory and Practice and either Auditing or Law regardless of the grade in the subject failed.

Such a conditioned candidate is entitled to retain his passing grades and repeat the examinations in the subject or subjects in which he failed. He may make as many as three attempts to work off the condition, if necessary, but he must complete these trials within a period of three years from the date of the examination on which he qualified for condition.

Of the 990 candidates who wrote the two examinations reviewed in this article, the following achieved condition status:

November 1957	119
May 1958	118
Total	237

Included in the above figures are the candidates who had achieved condition status in earlier examinations and who failed to pass in the conditioned subject, but who are entitled to further trials in future examinations.

The Candidates Who Failed

The competition in this examination is quite intense, and there are always some who fail to pass or to attain condition status. For such candidates, further study is in order. The regulations require that they may not write again until at least one examination shall have intervened, and even then they must submit proof that they have made further preparation in the subjects failed. In November, 1957, 271 candidates failed to pass or to attain condition status, and in May, 1958, the number was 222.

The Successful Candidates

It is a very thrilling experience for a candidate to receive notification that he has passed the CPA examination. For all, it means periods of devotion to intensive study, and for some it represents years of concentrated effort. It is indeed an outstanding accomplishment.

The Illinois Society of Certified Public Accountants, some years ago instituted a practice which adds greatly to the ceremony of awarding

he Illinois CPA certificates. The uccessful candidates on each examnation are guests of the Illinois Society at a very fine dinner in the all room of the Palmer House. Two f these awards dinners are held each ear. At the dinners, a University f Illinois official presents the CPA ertificates to the successful candilates. A speaker of distinction adlresses the group and the candidates who achieved the highest marks on he examinations are presented gold nd silver medals by the Society. The andidate may bring as his guests to he dinner his wife, or his parents, or riends who would like to share with im the pleasure of the occasion.

For the November 1957 examinaion, there were 158 men and 3 women, nd for the May 1958 examination, 99 nen and no women who received CPA ertificates. Thus for the two examiations there were 257 men and 3 women or a total of 260 who qualified.

Those who received medals in these wo examinations are:

November 1957 examination:

Gold Medal—Jerry W. Kolb
Silver Medal—Arthur I. Farber

May 1958 examination:

Gold Medal—Jack Skerball Levin
Silver Medal—Thomas Michael McDonald

One provision in the Illinois Acountancy Act is that the candidate, to ualify for the CPA certificate, must e at least 21 years of age. Only 28% f the successful candidates in these wo examinations were under 25 years f age. The number of successful andidates in the group whose ages ange from 25 to 29 increased substanially—40%. Eighty-eight percent 88%) of those who passed were nder 35 years of age. The successful candidates fall into the following age groups:

	November 1957	May 1958
21-24 years of age	40	33
25-29 years of age	65	39
30-34 years of age	36	17
35-39 years of age	12	7
40 years or older	8	3
Totals	161	99

The CPA examination is a very difficult examination to pass, and only a relatively small number of the successful candidates pass on their first trial. In the two examinations under discussion, 34% passed on the first trial; 29% on the second; 16% on the third; 10% on the fourth. Thus approximately 89% of the successful candidates passed on either the first, second, third, or fourth attempt. The table below indicates the number of successful candidates in the two examinations, who passed after the indicated number of trials.

	November 1957	May 1958
Passed, 1st examination	52	37
Passed, 2nd examination	48	29
Passed, 3rd examination	28	13
Passed, 4th examination	17	10
Passed, 5th examination	7	5
Passed, 6th examination	5	5
Passed, 7th examination	1	0
Passed, 8th examination	2	0
Passed, 9th examination	1	0
Totals	161	99

Adequate preparation is strongly recommended for the CPA examination. In fact, the Illinois Accountancy Act has been recently amended to specify higher educational standards. The candidates in these two examinations were required to present evidence that they had 30 semester

hours of credit in Accountancy, Business Law, Economics, and Finance, and that at least 20 semester hours of this work was in Accounting and Auditing. This will continue to be the educational requirements for those who apply for the examination prior to January 1, 1961. Those who apply between January 1, 1961 and January 1, 1964 must present evidence of 60 semester hours of college work, at least 21 of which must be Accounting and Auditing; those who apply be-between January 1, 1964 and January 1, 1967 must present evidence of 90 semester hours of credit, at least 24 of which shall be in the study of Accounting, Auditing, and Business Law; those who apply after January 1, 1967, must present evidence of 120 semester hours of credit, at least 27 of which are to be in the field of Accounting, Auditing, and Business Law.

Most of the candidates who are successful in the examination have had much more than the minimum of 30 hours of credit as specified in the Accounting Act. There is substantial evidence that a person who completes a four year college education and obtains a degree has much better chance of passing the CPA examination.

The table below indicates the amount of preparation presented by the successful candidates in these two examinations.

Educational Background	Successful Candidates Nov. 1957	Successful Candidates 1958 May
High school graduation plus 30 hours minimum prescribed	36	22
College degrees	98	60
College degree plus graduate study or further professional study	27	17
Total successful candidates	161	99

Many states require the candidate to present evidence of accounting practice or experience. This has never been required in the State of Illinois. The value of accounting experience, however, is indicated by the table below, which indicates the number of years experience reported by the successful candidates in these two examinations. Only a relatively small number passed the examinations without any accounting experience.

Experience Background	Successful Candidates November 1957	Successful Candidates May 1958
No experience	24	31
One year experience	51	18
Two years experience	25	25
Three years experience	14	11
Four years experience	10	4
Five years experience and over	37	10
Total successful candidates	161	99

Composite Picture of the Two Examinations

Gathering together the results of these two examinations, we have the following information. Of the 990 candidates who wrote the examination, 260 (26.26%) passed and received the CPA certificate. This represents an improvement over the previous two examinations where 23.4% passed. This upward trend in the percentage of candidates successful has continued now for a number of examinations, supporting the belief that the requirement for increased study and preparation is, in fact, proving a benefit to the candidate.

Of the 260 successful candidates, 124 (12.52%) passed the entire examination at one time (not necessarily the first time). Here also we note an increase over the two preceding exam-

ations where the percentage was 79%. In the two examinations prior that, the percentage was still lower,)4%. Here again is evidence that e preparation of the candidate is proving from year to year. One-ndred thirty-five passed in the No-mber, 1957, and May 1958 examina-ns, under provision of the condition le. This represents 13.63% of the al candidates writing as compared th 14.31% in the two examinations mediately preceding.

In the two examinations here dis-ssed, 16.26% of the candidates quired new condition status, and additional 7.67% failed to pass der the condition rule and still ve one or two additional trials to rk off the condition in the subject subjects failed. Four hundred nety-three (493) or 49.79% failed pass the examination or to achieve y condition status. In the two ex-inations under discussion in this icle, 22% of those who passed met minimum education requirement of 30 semester hours in the study of Accounting and related subjects, but had no college degree. This compares with 17% in the two preceding exam-inations. About 78% of the successful candidates of the two examinations had college degrees, and of this number, 21% had graduate training or professional training beyond the bachelor's degree. These figures cor-respond to 83% and 16% in the two preceding examinations.

In the two examinations, 21% of the successful candidates showed no experience. This is substantially the same in the two preceding exami-nations (20%), and it is exactly the same percentage as in the two exam-inations in November, 1955 and May, 1956, Fifty-five percent (55%) of the successful candidates in the Novem-ber, 1957, and May, 1958 examina-tions had 1, 2, or 3 years of public accounting experience as compared with 51% in the two previous exami-nations, 33% in the examinations of November, 1955 and May, 1956.

What's In It For You?

(Continued from page 31)

the Illinois Society of Certified blic Accountants, each one of se who are most active can feel this ra indescribable intangible that re-ts when he participates actively on nmittees, in technical meetings, and other society activities.

Are you active in your society's work? You could be—and you should be active if you want to gain a greater benefit from your membership. Your society has a very full program, and you belong in it. Anything you can do alone, we can do better together.

NEW MEMBERS OF THE ILLINOIS SOCIETY

(Addresses are in Chicago unless otherwise indicated)

New Members Elected February 16, 1959

Frank Anstadt
Oher, Anstadt & Co.
533 S. Dearborn Street (5)

Theron R. Beeson
206½ W. Second Street
Kewanee, Illinois

Francis V. Boyd
Northwestern University
School of Business
Evanston, Illinois

Robert A. Bransley
Eberhard S. Blanck & Co.
110 S. Dearborn Street (3)

Robert P. Butler
Murphy, Lanier & Quinn
231 S. La Salle Street (4)

Robert C. Campbell
Beckerman, Terrell & Co.
188 W. Randolph Street (1)

Irving M. Converse
Thor Power Tool Company
175 N. State Street
Aurora, Illinois

Sidney Davidson
University of Chicago
School of Business (37)

William J. Falstad
Arthur Andersen & Co.
120 S. La Salle Street (3)

Edward Eppenstein
6754 N. Sheridan Road (26)

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Chicago Title and Trust Co.
111 W. Washington Street (2)

John V. Giovenco
Harris, Kerr, Forster & Company
220 S. State Street (4)

Earl Hassett
Atwood Vacuum Machine Company
1400 Eddy Avenue
Rockford, Illinois

Nathan W. Helman
Mount Sinai Hospital
2755 W. 15th Street (8)

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Golman, Brookstone & Co.
105 W. Adams Street (3)

Jack C. Hoffmann
American Thermos Products Co.
Macomb, Illinois

Donald J. Holzinger
Dohrn Transfer Co.
208—18th Street
Rock Island, Illinois

Julius H. Hull
Doty & Doty
134 S. La Salle Street (3)

James W. Humphrey
Ray A. Howard
75 E. Wacker Drive (1)

Gordon M. Johns
University of Illinois
David Kinley Hall
Urbana, Illinois

James P. Joice
International Packers Limited
135 S. La Salle Street (3)

Edward C. Jordan
Booz, Allen & Hamilton
135 S. La Salle Street (3)

Norman J. Kautt
1401 N. Austin Boulevard (51)

Douglas W. Kendrick
Arthur Andersen & Co.
120 S. La Salle Street (3)

John S. Koach
129½ E. Lincoln Highway
DeKalb, Illinois

Bernard J. Lechner
J. W. North and Co.
105 W. Adams Street (3)

Edward Lemanski
Haskins & Sells
141 W. Jackson Boulevard (4)

Jack S. Levin
Harvard Law School
Cambridge, Massachusetts

Theodore I. Lundquist
616 Shaw Street
Rockford, Illinois

Arthur T. Macklin, Jr.
Carson Pirie Scott & Co.
1 S. State Street (3)

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Haskins & Sells
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141 W. Jackson Boulevard (4)

VING F. NOPARSTAK
6350 N. Clark Street (26)

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Arthur Andersen & Co.
120 S. La Salle Street (3)

ARRY S. PROVO
Chicago and North Western Railway
400 W. Madison Street (6)

ICHARD J. QUINN
Bansley and Kiener
130 N. Wells Street (6)

HOMAS H. RANDOLPH
Peat, Marwick, Mitchell & Co.
10 S. La Salle Street (3)

DWARD E. RENNHACK
Central Farmers Fertilizer Co.
205 W. Wacker Drive (6)

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4753 N. Broadway (40)

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La Grange, Illinois

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(Military Service)

DON E. WILLIAMS
Arthur Young & Company
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MERVYN W. WINGFIELD
University of Illinois
David Kinley Hall
Urbana, Illinois

New Members Elected March 17, 1959

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Ernst & Ernst
314 N. Broadway
St. Louis 2, Missouri

RVAL D. BAST
C. H. Worcester Estate
53 W. Jackson Boulevard (4)

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Winakor & Myers
207 W. University Avenue
Champaign, Illinois

OBERT D. BATY
Hall, Penny, Jackson & Co.
105 W. Adams Street (3)

GMUND B. BERGESEN
Haskins & Sells
141 W. Jackson Boulevard (4)

AVID B. BIRKENSTEIN
A. R. Ellman & Co.
360 N. Michigan Avenue (1)

HAROLD R. BLAND
134 S. La Salle Street (3)

BASIL O. BOOTON
Lilienfeld & Co.
121 W. Wacker Drive (1)

RUSSELL M. BRAGA
Joseph T. Ryerson & Son, Inc.
P. O. Box 8000-A (80)

LESLIE A. BRANDT
The Peoples Gas Light and Coke Co.
122 S. Michigan Avenue (3)

EDWARD P. CARROLL
Murphy, Lanier & Quinn
231 S. La Salle Street (4)

JAMES C. CRAY
Bansley and Kiener
130 N. Wells Street (6)

RANDALL L. DOBBINS
Peat, Marwick, Mitchell & Co.
10 S. La Salle Street (3)

EDWARD M. FORTIN
Englewood Electrical Supply Co.
5801 S. Halsted Street (21)

ROBERT E. GENTRY
University of Illinois
101 Administration (E)
Urbana, Illinois

CECIL M. GILLESPIE
Northwestern University
School of Business
Evanston, Illinois

HERBERT GOLDSTEIN
141 W. Jackson Boulevard (4)

NEVIN C. GORTNER
Arthur Andersen & Co.
120 S. La Salle Street (3)

CHARLES H. GRIFFIN
University of Illinois
David Kinley Hall
Urbana, Illinois

LAWRENCE J. GRILL
Arthur Andersen & Co.
120 S. La Salle Street (3)

CAMERON D. HUDDLESTONE
U. S. Internal Revenue Service
Post Office Building
Champaign, Illinois

RONALD S. KATCH
134 N. La Salle Street (2)

LLOYD C. MCKENZIE
Gray, Hunter, Stenn & Co.
35 E. Wacker Drive (1)

HARVEY N. MEDVIN
Scovell, Wellington & Company
105 W. Adams Street (3)

CHRISTIAN D. MEISLAHN
Litchfield Creamery Company
120 W. St. John Street
Litchfield, Illinois

SHELDON P. MIGDAL
Northwestern University
School of Law

RICHARD M. MOEN
Arthur Hamer & Co.
9035 S. Western Avenue (20)

F. A. NORDEN III
General American Transportation Cor
135 S. La Salle Street (3)

GEORGE E. PEARSON
Radio Industries, Inc.
666 Garland Place
Des Plaines, Illinois

TULIO C. POLSINELLI
Peat, Marwick, Mitchell & Co.
10 S. La Salle Street (3)

ARTHUR A. RONAT
Internal Revenue Service
Intelligence Division
P. O. Box 666
Springfield, Illinois

EUGENE T. SCHULER
Air Comfort Corporation
816 N. Kostner Avenue (51)

EDWARD F. SHAUGHNESSY, JR.
Arthur Andersen & Co.
120 S. La Salle Street (3)

LOUIS R. SHAW
Shaw, Stout and Tobin
141 W. Jackson Boulevard (4)

ROBERT M. SHEHAN
Touche, Niven, Bailey & Smart
208 S. La Salle Street (4)

FRANCIS J. SPACHMAN
Spachman & Faierson
7 S. Dearborn Street (3)

DON W. SWANSON
Hall, Penny, Jackson & Co.
105 W. Adams Street (3)

BERNARD H. TRAUT
Bansley and Kiener
128 N. Wells Street (6)

RONALD B. VLACH
United States Steel Corp.
3426 E. 89th Street (17)

New Members Elected April 16, 1959

DONALD G. BRADY
Gauger & Diehl
208 Citizens Building
Decatur, Illinois

LUCILLE M. DUFF
12514 S. Western Avenue
Blue Island, Illinois

NORRIS K. EKSTROM
Link-Belt Company
Prudential Plaza (1)

JOSEPH A. GEISEN
Alexander Grant & Company
1 N. La Salle Street (2)

OSEPH F. GLOTZBACH
Glotzbach and O'Dell
5305 Hohman Avenue
Hammond, Indiana

ICHAEL J. HANDZEL
Haskins & Sells
141 W. Jackson Boulevard (4)

AROLD S. HINDS
Wolf and Company
7 S. Dearborn Street (3)

AMES H. HURT, JR.
Arthur Andersen & Co.
120 S. La Salle Street (3)

OHN G. KEARINS
Arthur Andersen & Co.
120 S. La Salle Street (3)

AVID KLEINERMAN
Roosevelt University
430 S. Michigan Avenue (5)

OWARD A. L. LANDON
Price Waterhouse & Co.
Prudential Plaza (1)

LAN LEVINE
Philip G. Garfinkle
1737 Howard Street (26)

OSEPH S. MCGEE
Hoffman Electronics Corp.
930 Pitner Avenue
Evanston, Illinois

ICHARD F. MILLEN
Chemetron Corp.
840 N. Michigan Avenue (11)

JOSEPH NEPUTY
Cory Corporation
3200 W. Peterson Avenue (45)

DONOVAN M. OLSON
General Outdoor Advertising Co., Inc.
515 S. Loomis (7)

JOHN F. O'SULLIVAN
Arthur Andersen & Co.
120 S. La Salle Street (3)

FRANCIS W. R. PELMAN
Peat, Marwick, Mitchell & Co.
10 S. La Salle Street (3)

JOHN A. SCHOLZ
Edward F. Roche & Co.
13053 S. Western Avenue
Blue Island, Illinois

DONALD B. SCHONEBERGER
The Paper Mate Company
444 Merchandise Mart (54)

RICHARD R. SCHUBERT
Price Waterhouse & Co.
Prudential Plaza (1)

CARROLL L. SHAUGHNESSY
Arthur Young & Company
1 N. La Salle Street (2)

JOHN J. SKUBIZ
Monarch Hardwood Lumber Co.
3250 N. Kedzie Avenue (18)

JOHN T. WOODS
Delaney and Woods
135 S. La Salle Street (3)